Insurance Law

How to Preserve a Bad Faith Claim for a Defending Insurer's Unreasonable Refusal to Settle

by Richard Huver, Column Editor

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An insurance carrier owes a duty to defend its insured against a lawsuit and indemnify the insured to the extent of the insurance policy's coverage limits. As part of its duty, the insurer is obligated to accept a reasonable settlement demand made within policy limits, subject to certain conditions (including, *inter alia*, that liability against its insured is reasonably clear, that the insurer has had sufficient time to investigate the merits of the claim, and that the insurer is given a reasonable time to accept the settlement demand).

Failure to timely accept such a settlement demand can expose the insurer to liability for the amount of a subsequent judgment against its insured (even if it exceeds policy limits), and, in certain circumstances, can give rise to liability for emotional distress, attorney's fees and punitive damages.

One critical element of a bad faith claim arising from a defending insurer's failure to accept a reasonable settlement demand is existence of actual damages to the insured. When the defending insurance company refuses to settle the case, does the insured's stipulation to judgment against itself and assignment to the underlying plaintiff of its bad faith claims against its insurance company satisfy the essential element of damages? The simple answer is probably

not, as illustrated by the recent case of *Wolkowitz v. Redland Insurance Co.* (2003) 112 Cal.App.4th 154, 5 Cal.Rptr.3d 95, and as confirmed by the Supreme Court last year in *Hamilton v. Maryland Casualty Co.* (2002) 27 Cal.4th 718.

The factual background in *Wolkowitz* is fairly elaborate but necessary for a clear understanding of the court's ruling. A vehicle owner, Choy, was injured as a result of a defective "lift kit" installed on his vehicle by a company called Shamrock. Choy suffered serious injuries and filed suit against Shamrock and others. Shamrock's insurer, Redland Insurance Company, retained an attorney to defend Shamrock against the lawsuit. During the course of litigation, an offer was made to settle Choy's claims for the available $500,000 liability insurance limits. For reasons not spelled out in the opinion, the insurer "refused" to accept the offer. *Wolkowitz v. Redland Ins. Co.*, *supra*, 5 Cal. Rptr.3d at 98-99.

Choy then offered to enter into an agreement not to execute a judgment against Shamrock in exchange for an assignment of Shamrock's bad faith cause of action against its insurer for refusing to accept the policy limits demand. *Id*. at 99. [A follow-up article will discuss the differences between taking an assignment of rights in this situation versus having the insured proceed with the bad faith action and giving the underlying plaintiff a lien against the recovery.]

Shamrock's attorneys allegedly failed to advise the insurance company of Choy's offer. Shamrock later filed for bankruptcy protection on the advice of its insurer-retained attorneys. The bankruptcy trustee then entered into an agreement with Choy which provided that (1) the settlement was binding only if approved by the bankruptcy court, (2) the parties would use their best efforts to obtain approval for the settlement agreement from the court, (3) the two shared a "common interest" in maximizing the bankruptcy estate by recovering a judgment against the insurer in excess of the $500,000 limits demand, (4) Choy's claim was worth $26,225,000, and

(5) the claim would be allowed without objection from the trustee as a general unsecured claim. The agreement also provided that Choy would look solely to the proceeds recovered against the insurance carrier in the bad faith action to satisfy his unsecured claim. *Wolkowitz v. Redland Insurance Co., supra,* at 99-100.

Shamrock's bankruptcy trustee petitioned the bankruptcy court for approval of the settlement agreement and to allow Choy's claim. Notice was given to all concerned, including Shamrock's insurance company, Redland. Neither Redland nor any other party opposed the petition and the claim was allowed by the court. *Id.* at 100.

Following the order of the bankruptcy court, the trustee filed an action for bad faith against Redland (there were other claims against the insurer-retained attorneys which are not relevant for purposes of this article) alleging, inter alia, that the insurer had unreasonably and in bad faith refused to accept Choy's policy limits offer. The complaint alleged that the bankruptcy court's "allowance" of Choy's $26,225,000 claim constituted a "final judgment" against Choy. *Id.*

Redland finally stepped into the fray, filing an answer to the bad faith complaint as well as its own complaint for declaratory relief seeking a judicial determination regarding the significance of the bankruptcy court's allowance of Choy's claim. The insurer's declaratory relief action alleged that the bankruptcy court's order allowing Choy's claim "did not constitute a judgment after trial and therefore could not, as a matter of law, support liability for" bad faith. *Wolkowitz v. Redland Ins. Co.*, *supra,* at 100-101. The declaratory relief action was filed in federal court while the trustee's bad faith action had been filed in state court.

With the facts fully fleshed out, let us turn now to the procedural outcome of the various actions. First, the federal action was stayed pending resolution of the trustee's bad faith action in

state court. The state court then sustained Redland's demurrer without leave to amend and dismissed the trustee's complaint, concluding that there was no final judgment in the underlying personal injury action and the settlement agreement in the bankruptcy court did not constitute a final judgment. As a result, Shamrock suffered no damages (because Choy's claim was unenforceable). And because there were no damages, the bad faith action against Redland for failure to settle within policy limits was dismissed. *Wolkowitz v. Redland Ins. Co., supra,* at 101.

Upon this record, the trustee appealed. The Second District Court of Appeal needed to look no further than the California Supreme Court's decision last year in *Hamilton v. Maryland Casualty Co.* (2002) 27 Cal.4th 718 to affirm the trial court's ruling.

In *Hamilton*, a liability insurer refused a settlement demand made against its insured which was within policy limits. The claimant and the insured then agreed on a settlement whereby a stipulated judgment was entered against the insured, the claimant agreed not to execute on the judgment against the insured, and the insured assigned its bad faith cause of action to the claimant. The trial court approved the settlement agreement as having been made in good faith pursuant to California Code of Civil Procedure §877.6. The insurance company did not participate in the settlement although it was defending the insured against the lawsuit. *Hamilton v. Maryland Casualty Co., supra,* 27 Cal.4th at 721-22.

The Supreme Court concluded that the stipulated judgment, although approved by the trial court, was not binding on the insurer as to the essential element of the amount of damages suffered by the insured, ruling:

> **[W]here the insurer has accepted defense of the action, no trial has been held to determine the insured's liability, and a covenant not to execute excuses the insured from bearing any actual liability from the stipulated judgment, the entry of a stipulated judgment is insufficient to show, even rebuttably, that**

> **the insured has been injured to <u>any</u> extent by the failure to settle, much less in the amount of the stipulated judgment. In these circumstances, the judgment provides no reliable basis to establish damages resulting from a refusal to settle, an essential element of plaintiffs' cause of action.**

Id. at 726.

The *Wolkowitz* court echoed the *Hamilton* court's holding in rejecting the settlement agreement between Choy and Shamrock as satisfying the requisite damages element, reasoning:

> **Until a judgment has been entered against the insured after a trial, there is no assurance that the insured will suffer any damage from the insurer's breach of its implied obligation to accept a reasonable settlement offer.**

Wolkowitz v. Redland Ins. Co., supra, 5 Cal.Rptr.3d at 103. *See also, Safeco Ins. Co. v. Superior Court* (1999) 71 Cal.App.4th 782, 788 ("[u]ntil judgment is actually entered, the mere possibility or probability of an excess judgment does not render the refusal to settle actionable.")

But what about the bankruptcy court's allowance of Choy's claim without objection from Redland? Doesn't that elevate the "agreement" to something equivalent to a post-trial judgment? Not in this situation.

Because the insurer was defending Shamrock against Choy's lawsuit, the insurer and not the insured controlled defense of the case. Unlike a situation in which the insurer refuses to defend its insured, in the *Wolkowitz* case Redland's decision to reject Choy's settlement offer, by itself, was insufficient to succeed on a bad faith liability claim. More needed to occur. Had Choy taken his case to trial against Shamrock **and** been awarded an amount in excess of the policy limits, then real damages would have accrued. But without such a finding at trial as to both the liability and damages issues, a settlement agreement such as that entered into between the insured and the claimant is insufficient evidence of damages, even if the insurer's refusal to settle was unreasonable. As the Supreme Court noted in *Hamilton*:

> **Where, as here, [an] insured, without [an] insurer's agreement, stipulates to a judgment against it in excess of both the policy limits and the previously rejected settlement offer, and the stipulated judgment is coupled with a covenant not to execute, the agreed judgment cannot fairly be attributed to the insurer's conduct, even if the insurer's refusal to settle within the policy limits was unreasonable.**

Hamilton v. Maryland, supra, 27 Cal.4th at 731.

The *Hamilton* court had explained the reasons why the good faith determination did not equate to a judgment after trial:

> **(1) there was no evidentiary hearing to determine the insured's liability, (2) the settlement resulted from negotiation rather than factfinding, and (3) the purpose of a good faith determination is to ensure that the settling tortfeasor pays no less than its proportionate share of liability, while the insurer's concern is that the insured pay no more than its share.**

Id. at 729-30.

The *Wolkowitz* court used the same reasoning to hold the "allowance" by the bankruptcy court of Choy's claim did not equate to a judgment, noting:

> **The bankruptcy court did not determine the validity and amount of Choy's claim after a contested evidentiary hearing. Rather, the bankruptcy court simply granted the trustee's unopposed motion to allow Choy's claim. The trustee not only made no objection to that claim, but in fact moved the bankruptcy court to allow it for the clear purpose of "benefitting" the estate by creating a basis for suing Redland.... the bankruptcy court's order was not a judicial finding that Shamrock was actually liable to Choy in the agreed amount. This is true regardless of the preclusive effect that the allowed claim may have in some other context.**

Wolkowitz v. Redland Insurance Co., supra, 5 Cal.Rptr.3d at 105. The *Wolkowitz* court concluded, "the debtor's insurer based on an unreasonable refusal to settle, the bankruptcy court's approval of an uncontested claim without an evidentiary hearing provides no reasonable basis to establish damages resulting from the refusal to settle." *Id.* at 106.

Remember to take the lessons from the *Wolkowitz v. Redland Ins. Co.* and *Hamilton v. Maryland* cases to heart before agreeing to a stipulated judgment and an assignment of bad faith claims in a similar situation.