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RECENT DEVELOPMENTS

Insurance—Limitations on Insurers’ Liability for Bad Faith Refusal To Defend and To Consider Settlement Opportunities

Gordon v. Nationwide Mutual Insurance Co.,
30 N.Y.2d 427, 285 N.E.2d 849,
334 N.Y.S.2d 601 (1972)

Modern liability insurance policies usually include a promise by the insurer to defend all suits against its insured, qualified by a reserved right to settle a claim "as it deems expedient." The insurance company additionally promises to satisfy judgments (or written settlements) against its insured to the extent of the policy limits. In return, the insured pledges to cooperate in the company’s defense strategy and not to assume any independent obligation voluntarily. The typical insurance contract thus imposes on the insurer an express obligation to defend lawsuits against its insured, but no firm duty to settle.

Although no formal duty to settle exists, the insured’s promise to cooperate and to resist incurring any independent obligation places ex-

1 A typical clause reads as follows:

[T]he Company shall: (a) defend any suit against the Insured alleging such injury, sickness, disease or destruction and seeking damages on account thereof, even if such suit is groundless, false or fraudulent; but the Company may make such investigation, negotiation and settlement of any claim or suit as it deems expedient...


New York courts have construed such clauses to require the insurer to defend all lawsuits whose allegations bring them within the coverage of the policy, even if they are eventually decided in favor of the insured. If the complaint in the action against the insured alleges upon its face facts which bring the action within the coverage of the policy, the insurer must assume defense of the action or face damages for breach of contract. See Goldberg v. Lumber Mut. Cas. Ins. Co., 297 N.Y. 148, 77 N.E.2d 131 (1947).

2 No action shall lie against the Company unless, as a condition precedent thereto, the Insured shall have fully complied with all the terms of this policy, nor until the amount of the Insured’s obligation to pay shall have been finally determined either by judgment against the Insured after actual trial or by written agreement of the Insured, the claimant and the Company.

Quoted in Record at 292(3).

3 The Insured shall cooperate with the Company and, upon the Company’s request, shall attend hearings and trials and shall assist in effecting settlements, securing and giving evidence, obtaining the attendance of witnesses and in the conduct of suits. The Insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any expense other than for such immediate medical and surgical relief to others as shall be imperative at the time of accident.

Id. at 292(4) (emphasis in original).
inclusive control over settlement decisions in the hands of the insurer. The interests of the insurer and its insured, however, often clash when a recovery of an adverse judgment in excess of the policy limits is possible. Consequently, many courts have held that the insurer has a good faith duty to consider the insured's interest, as well as its own, in handling claims and negotiating settlements, even though such responsibility was not expressly stated in the insurance contract. Breaches of this implied duty of good faith occur most frequently when the insurer unreasonably or perfidiously decides to litigate rather than settle a claim thereby exposing its insured to a judgment in excess of policy limits.

In recent years many jurisdictions have imposed liability in excess of policy limits on an insurer who in bad faith breaches its covenant to defend and who also fails to consider settlement opportunities. However, in Gordon v. Nationwide Mutual Insurance Co., the New York Court of Appeals, considering the issue for the first time since 1928,

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4 One of the primary purposes of the policy always has been to protect the insured against the expense and inconvenience of litigation. The investigation of the third person's claim, negotiation with the claimant, the posting of a bond when it is required, or even providing bail where there is an arrest, the defense of the action brought against the insured, the payment of attorney's fees and all other expenses which it may involve, and frequently, today, the payment of first-aid medical expenses of the injured person even though there is no liability and no claim is made—all these have become recognized as the responsibility of the insurer.


9 The New York Court of Appeals has never approved the imposition of liability.
refused to impose liability on an insurer who refused to defend or settle. Because the members of the court were so sharply divided in their analyses and resolution of the major issues, the future impact of the case is difficult to ascertain. Nevertheless, it appears certain that the majority opinion will present significant obstacles to future recovery by insureds and their representatives.

I

BACKGROUND AND BASIC RATIONALE OF Gordon

Louis Porter was insured under an automobile liability insurance policy written by the Nationwide Mutual Insurance Company. When he breached his contract to pay installments to the finance company which had paid the annual premium on the policy, the finance company sent a notice of cancellation to both Porter and Nationwide. Because this notice was technically deficient, it did not effectively termi-

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1 Undoubtedly, the absence of New York precedent imposing liability on the insurers in "the defend rather than settle" situation was an obstacle for the insured's representative in Gordon. On appeal, he could only assert that the good faith obligation has been a "cornerstone" of New York law since 1914 and rely on federal court, lower court, and secondary sources in referring to the duty to consider settlement opportunities in good faith. Brief for Plaintiff as Respondent and Cross-Appellant at 22-24, Gordon v. Nationwide Mut. Ins. Co., 20 N.Y.2d 427, 285 N.E.2d 849, 334 N.Y.S.2d 601 (1972). Judge Breitel, dissenting in Gordon, who would have held the insurer liable, mentioned only the "deep roots" of the good faith duty in New York. 20 N.Y.2d at 445, 285 N.E.2d at 859, 334 N.Y.S.2d at 615; cf. N.Y. Ins. Law § 40(d) (McKinney Supp. 1978) (imposing penalties upon insurers for "not attempting in good faith to effectuate prompt, fair and equitable settlements of claims submitted in which liability has become reasonably clear").
On November 28, 1961, five days after the purported cancellation, Porter was involved in a two-car collision. The driver of the other vehicle and his wife were killed, and another passenger was seriously injured. Porter disclaimed responsibility for the accident and promptly notified Nationwide.\(^\text{12}\)

The attorney for the decedents’ estates asserted claims against Porter in a letter which Porter forwarded to Nationwide. Subsequently, the claimants’ lawyer presented Nationwide with proposals to settle all claims arising out of the accident within the $20,000 policy limit.\(^\text{13}\) When the insurer did not respond, the attorney sued Porter. Nationwide initially assumed Porter’s defense, but after finding the notice of cancellation in its files, it notified Porter and the claimants’ lawyer that it was withdrawing and disclaiming liability. The claimants’ lawyer objected to the withdrawal and informed Porter of a New York Supreme Court case holding that a notice of cancellation similar to the one given Porter was ineffective.\(^\text{15}\) The claimants also renewed their offer to Porter to settle all claims within the policy limits and promised to delay action on them until Nationwide could obtain a declaratory judgment resolving the question of cancellation. When Nationwide withdrew, the claimants proceeded in their suit against Porter. Although he had been personally served, Porter failed to appear, and default judgments totaling $214,462.50 were entered against him.

\(^{11}\) The notice of cancellation was mailed to Porter on November 10, 1961, with a purported cancellation date of November 23. Record at 297. N.Y. BANKING LAW § 576(1)(b) (McKinney 1971), governing cancellations by premium finance agencies, requires ten days notice and an additional three days for mailing. In a separate action brought by the insured’s tort victims to recover the $20,000 policy limit, the court concluded that the attempted cancellation was ineffective because a full 13 days notice was not given by the finance agency and because the finance agency lacked authority to cancel. 30 N.Y.2d at 432, 285 N.E.2d at 851, 334 N.Y.S.2d at 604. See Rotsettis v. Nationwide Ins. Co., 58 Misc. 2d 667, 297 N.Y.S.2d 333 (Sup. Ct. 1967), aff’d, 31 App. Div. 2d 722, 297 N.Y.S.2d 712 (2d Dep’t 1968), appeal denied, 23 N.Y.2d 646 (1969); notes 16-17 and accompanying text infra.

In the principal case, Nationwide did not contend on appeal that the notice of cancellation satisfied the Banking Law requirements. The Court of Appeals therefore assumed that the defendant had been wrong as a matter of law in asserting that the policy had been cancelled. 30 N.Y.2d at 431, 285 N.E.2d at 850, 334 N.Y.S.2d at 603.

\(^{12}\) Record at 296.

\(^{13}\) Id. at 273-75.

\(^{14}\) Both Nationwide and its counsel, attorneys of record for Porter, sent Porter letters stating that they were withdrawing from the defense and recommended that he arrange substitute counsel. Neither Nationwide nor the attorneys, however, advised the insured of the possibility of excess liability, the opportunity to settle, or the consequences of his failure to retain independent counsel. Both erroneously advised him that the policy had been effectively cancelled before the accident. See id. at 276-79, 294-95.

\(^{15}\) Id. at 282. The case cited was Cannon v. Merchants Mut. Ins. Co., 35 Misc. 2d 625, 230 N.Y.S.2d 282 (Sup. Ct. 1962).
In a subsequent action brought by the estates under section 167 of the New York Insurance Law, Nationwide was held liable under the policy. The estates then secured the appointment of a receiver for Porter who brought an action for negligence and breach of an implied covenant of good faith against Nationwide in an attempt to recover the remainder of the judgment.

At trial, the court charged the jury that it could find for the plaintiff-receiver if the defendant-insurer had negligently or in bad faith abandoned Porter's defense and had refused to consider a continuing opportunity to settle within the policy limits. In a special verdict, the jury found for the plaintiff on both causes of action, and, as directed by the trial judge, awarded damages equal to the amount that the default judgments exceeded the policy limits. The appellate division, by a divided court, affirmed the findings of negligence and bad faith.

By a vote of four to three, the Court of Appeals reversed, holding that the record lacked sufficient evidence to support a finding of neglig-

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16 N.Y. Ins. Law § 167(1)(b) (McKinney 1966), provides:

In case judgment against the insured or his personal representative in an action brought to recover damages ... occasioned during the life of the policy or contract, shall remain unsatisfied at the expiration of thirty days from the serving of notice of entry of judgment upon the ... insurer, then an action may ... be maintained against the insurer under the terms of the policy or contract for the amount of such judgment not exceeding the amount of the applicable limit of coverage under such policy or contract.


18 The plaintiff's witnesses testified that when a tort action is pending and a question of policy coverage or cancellation arises, the customary insurance industry practice is to obtain independent counsel to sue for a declaratory judgment resolving the question of coverage before abandoning the insured. See Record at 125-74.

The attorney for the decedents' estates testified that neither the insurer nor its counsel had investigated the premium finance agreement or the policy endorsement, which was in Nationwide's possession, before advising Porter that there was no coverage. Id. at 103-04.

The trial court refused to charge on the insured's contributory negligence in failing to undertake his own defense but advised the jury that his negligence could be included in the overall consideration of Nationwide's fault. Id. at 263; see note 59 infra.

19 62 Misc. 2d at 691, 309 N.Y.S.2d at 422. The trial court struck an additional $300,000 award for punitive damages on the ground that the defendant's conduct was not "wanton and malicious" but was merely an "error of judgment based upon an honest belief that the policy of insurance had been validly cancelled." Id. at 695, 309 N.Y.S.2d at 427.

20 37 App. Div. 2d at 265, 323 N.Y.S.2d at 550. Neither of the two dissenters disagreed with the findings of Nationwide's bad faith and negligence. Justice Shapiro voted for a new trial on the issue of whether Porter's failure to defend the personal injury action constituted contributory negligence. Id. at 272-73, 323 N.Y.S.2d at 558-59; see note 59 infra. Justice Benjamin would have dismissed both causes of action on the ground that the plaintiff had not proven a "true loss" to Porter as a result of the insurer's conduct. Id. at 273-74, 323 N.Y.S.2d at 558-59; see notes 48-57 and accompanying text infra.
gence or bad faith on the part of Nationwide.21 Chief Judge Fuld concurred with the majority opinion written by Judge Bergan, but favored dismissal on the additional ground that the plaintiff had failed to prove any actual damages to the insured.22 Judge Breitel and two fellow dissenters agreed with the trial court's findings of bad faith and negligence, but voted to reverse and ordered a new trial to determine the insured's actual damages.23

II

ALTERNATIVE JUDICIAL APPROACHES TO
INSURERS' LIABILITY

The majority of the Court of Appeals recognized that the plaintiff's claim was based on the theory that Nationwide had breached the duty of good faith which it owed Porter by virtue of its liability contract. By refusing to settle or defend the negligence claims against Porter within the policy limits, the insurance company exposed Porter to liability in an amount equal to twelve-and-a-half times the policy limit.24

The majority relied on general contract law in concluding that a recovery for breach of an implied covenant of good faith is essentially punitive in nature.25 The majority then reasoned that because recovery

22 Id. at 439-41, 285 N.E.2d at 856-57, 334 N.Y.S.2d at 611-12; see notes 48-60 and accompanying text infra.
23 30 N.Y.2d at 441-53, 285 N.E.2d at 857-64, 334 N.Y.S.2d at 612-23; see notes 48-60 and accompanying text infra.
24 30 N.Y.2d at 431, 285 N.E.2d at 850, 334 N.Y.S.2d at 603.
25 Id. at 437, 285 N.E.2d at 854, 334 N.Y.S.2d at 606. Judge Bergan's conclusion is based on suspect authority. He relied primarily on Van Valkenburgh v. Hayden Publ. Co., 30 N.Y.2d 34, 281 N.E.2d 142, 330 N.Y.S.2d 329 (1972), in which the principal issue was whether a publisher had breached an express contractual covenant or an implied covenant of good faith and fair dealing. The court in Van Valkenburgh affirmed the appellate division's conclusion that only a narrow breach of the express promise had occurred and therefore that the plaintiff-author's request for equitable injunctive relief, in addition to monetary damages, had been properly denied. Id. at 46, 281 N.E.2d at 145, 330 N.Y.S.2d at 334. Even assuming the tangential relevance of a copyright-infringement contract case to an insurance contract case, a decision to grant equitable relief clearly involves different considerations than a decision to award punitive damages. Also, although the damage award in Gordon may have seemed punitive in effect because it exceeded Porter's probable actual loss, it does not automatically follow that awarding damages for an insurer's breach of good faith in handling claims against its insured is necessarily punitive in nature.

The majority offers no direct authority to support a conclusion that such an award is punitive. If the court's true concern was with the excessive amount of damages, which were twelve-and-a-half times the policy limit, the appropriate approach would have been to articulate rules for accurately measuring actual damage instead of undercutting the basis of the insurer's liability. See notes 48-60 and accompanying text infra.
in excess of policy limits for bad faith has a punitive purpose, the insurer's bad faith conduct must be so severe as to warrant punishment before any legal liability should be imposed. Judge Bergan found that bad faith standard to be one which demanded "an extraordinary showing of a disingenuous or dishonest failure to carry out a contract." Applying this strict definition to Nationwide's conduct in the instant case, the majority concluded that "bad faith may not possibly be inferred from [Nationwide's] failure to settle for the extent of its coverage at that early and indecisive stage of the litigation." Thus, the

26 30 N.Y.2d at 437, 285 N.E.2d at 854, 334 N.Y.S.2d at 609. The appellate division did not formulate a definition of bad faith, but the trial judge had granted the following jury instruction suggested by Nationwide:

I charge you that bad faith and mistaken judgment are to be distinguished. Bad faith implies the deliberate doing of something that the actor knows to be wrong. A mistake of judgment is not bad faith. The term "bad faith" embraces and connotes deceit, dishonesty, one-sidedness of intention or purpose.

Record at 260. This definition is not radically different from Judge Bergan's formulation.

The trial judge's charge on negligence was as follows:

Negligence is the lack of ordinary care. That's all it means. It's a failure to exercise that degree of care which a reasonable [sic] prudent person or corporation would have exercised under the same or similar circumstances.

... A general custom, usage or practice in the insurance industry, if proved to your satisfaction, may establish a standard of reasonable conduct in the insurance industry.

Id. at 256-57.

27 30 N.Y.2d at 435, 285 N.E.2d at 853, 334 N.Y.S.2d at 607 (emphasis added). This "early and indecisive stage of litigation" was 11 months after Nationwide had received notice of the accident, personal injury claims, and request to settle, and four months after the commencement of the action, and after Nationwide had filed an answer and requested a bill of particulars and an examination of the claimants before trial. Cf. Allstate Ins. Co. v. Gross, 27 N.Y.2d 263, 265 N.E.2d 736, 317 N.Y.S.2d 309 (1970). In Allstate, the court held the insurer's seven-month delay in disclaiming liability to be unreasonable as a matter of law under N.Y. Ins. Law § 167(8) (McKinney 1966). The insurer had assumed the defense of an action against its insured, filed an answer, received a bill of particulars, and represented the insured in an examination before trial, although it had reserved the right to disclaim. The court in Allstate also concluded that no finding of prejudice to the insured or the injured plaintiff was necessary to its holding. 27 N.Y.2d at 269, 265 N.E.2d at 739, 317 N.Y.S.2d at 313; see Seward v. State Farm Mut. Auto. Ins. Co., 392 F.2d 722 (5th Cir. 1968) (duty to consider settlements in good faith does not arise until insurer aware of offer to settle within policy limits); Gibbs v. St. Paul Fire & Marine Ins. Co., 22 Utah 2d 263, 451 P.2d 766 (1969) (no good faith obligation imposed on insurer until suit filed or claim made against insured).

Nationwide argued on appeal that an insurer should not be obligated to settle within the policy limits on demand, regardless of the "merits of the action or the posture of the litigation." Brief for Defendant, Reply Brief as Appellant at 13. Certainly the merits of the action and the possibility of a sound defense are key factors in the insurer's decision not to settle. The majority pointed to Porter's accident report (Record at 296), disclaiming responsibility for the accident in concluding that the stage of litigation was indecisive. 30 N.Y.2d at 435, 285 N.E.2d at 853, 334 N.Y.S.2d at 607. The plaintiff did not contend, however, that there was a duty to settle, but only that there existed a duty to consider settle-
majority found insufficient evidence of bad faith to permit jury consider-
ation of the claim; Nationwide's conduct was viewed merely as an un-
justifiable refusal to defend. 28

Judge Breitel, dissenting, contended that an award of damages ex-
ceeding policy limits was essentially compensatory rather than punitive
in nature. 29 He recognized that the judgment in excess of the policy
limits entered against Porter after the insurer's withdrawal could have
caused actual economic harm to him and that compensation for that
harm was the crux of the plaintiff's claim. 30 Furthermore, Judge Breitel
refused to rely on bad faith as the sole basis of the defendant's liability.
Rather, he argued that the insurer's asserted liability stemmed from a
breach of the express promise to defend, combined with a breach of the
implied duty of good faith, "including the good faith consideration of
opportunities to settle, because of [the insurer's] exclusive control in
the management of claims." 31

ment opportunities in good faith, which encompassed a duty to investigate the merits of
the action and the danger of a verdict in excess of the policy limits. Nationwide apparently
did neither, and failed to pursue Porter's identification of an eyewitness in his accident
report. Id. at 442, 285 N.E.2d at 857, 334 N.Y.S.2d at 611; see Colbert v. Home Indem. Co.,
35 App. Div. 2d 326, 315 N.Y.S.2d 949 (4th Dep't 1970) (plaintiff estopped from challeng-
ing insurer's failure to settle when plaintiff insisted on proceeding to trial).

28 This conclusion is striking when compared to the lower courts' appraisal of the
evidence. The appellate division stated: "There was abundant evidence adduced at the
trial from which the jury could and did find bad faith on the part of Nationwide." 37
App. Div. 2d at 270, 323 N.Y.S.2d at 555. The trial court observed: "The evidence is clear
and convincing and without dispute, that the defendant breached an express provision of
its policy. . . . Equally clear and convincing is the proof that the defendant could have
settled all such claims." 62 Misc. 2d at 691, 309 N.Y.S.2d at 422.

30 Id.; see notes 48-60 and accompanying text infra.
31 30 N.Y.2d at 445, 285 N.E.2d at 859, 334 N.Y.S.2d at 615. Judge Breitel relied
heavily on the analysis presented in the leading case of Communale v. Traders & Gen. Ins.
Co., 50 Cal. 2d 654, 328 P.2d 198 (1958). In that case, the California Supreme Court ac-
knowledged that an insurer relinquishes its exclusive control of the litigation when it
refuses to defend, but explained:

[The reason [the insurer] was not in control of the litigation is that it wrongfully
refused to defend [its insured], and the breach of its express obligation to defend
did not release it from its implied duty to consider [its insured's] interest in the
settlement.

. . . An insurer who denies coverage does so at its own risk, and, although its
position may not have been entirely groundless, if the denial is found to be wrong-
ful it is liable for the full amount which will compensate the insured for all the
detriment caused by the insurer's breach of the express and implied obligations of
the contract. Certainly an insurer who not only rejected a reasonable offer of set-
tlement but also wrongfully refused to defend should be in no better position
than if it had assumed the defense and then declined to settle. The insurer should
not be permitted to profit by its own wrong.

Id. at 660, 328 P.2d at 202.

When an insurer decides not to defend a negligence action like that preceding Gordon,
RECENT DEVELOPMENTS

This combined-breach analysis of the dissent and its characterization of the instant action as one for compensatory damages form the basis of the dissent's disagreement with the majority's "punitive" standard of bad faith.\textsuperscript{32} The dissenters would have affirmed the appellate division's conclusion that, on the "totality of circumstances" surrounding Nationwide's decision not to defend \textit{and} its failure to settle, the jury could find bad faith and negligence.\textsuperscript{33}

Although other jurisdictions apply varying formulations in charg-

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\textsuperscript{32} See notes 27-28 and accompanying text \textit{supra}.

\textsuperscript{33} 37 App. Div. 2d at 270, 323 N.Y.S.2d at 555. Judge Breitel stated:

\textit{In this case, Nationwide compounded the wrong by completely removing itself from the case. It thus denied the insured not only his express contract right to a defense but also the implied right to have settlements considered in good faith. The wrong is the more egregious, bad faith having been found and the finding \textit{virtually compelled} by the record.}

30 N.Y.2d at 446, 285 N.E.2d at 860, 334 N.Y.S.2d at 616 (emphasis added).
ing juries on an insurer’s negligence or bad faith, the results turn more frequently on what courts consider sufficient evidence for jury consideration of an insurer’s liability rather than on abstract formulations of bad faith. Thus, the following factors, all present in the “totality of circumstances” in Gordon, have been considered in various combinations to support a conclusion that the insurer acted in bad faith: (1) failure to investigate properly whether the policy was in effect at the time of the accident, (2) failure to investigate the probability of a

34 For example, in Dumas v. Hartford Acc. & Indem. Co., 94 N.H. 484, 489, 56 A.2d 57, 60 (1947), the court stated:

Due care must be exercised in ascertaining all the facts of the case both as to liability and damages, in learning the law and in appraising the danger to the insured of being obliged to pay the excess portion of a verdict.

In Bowers v. Camden Fire Ins. Ass’n, 51 N.J. 62, 71, 237 A.2d 857, 861 (1969), the court noted:

Good faith is a broad concept. Whether it was adhered to by the carrier must depend upon the circumstances of the particular case. A decision not to settle must be a thoroughly honest, intelligent and objective one. It must be a realistic one when tested by the necessarily assumed expertise of the company.

The fundamental distinction between a bad faith standard and a negligence standard is that bad faith focuses on the subjective motivations of the insurer whereas negligence turns on the objective “reasonableness” of his conduct. To the extent that bad faith is evidenced by circumstances surrounding an insurer’s decision, commentators agree that the two tests have coalesced. See Appelman § 4712; Long § 5.13.


35 The trial record in Gordon supports the following conclusions: (2) Nationwide did not have the original premium finance agreement in its possession when its underwriting department made the determination of cancellation in the first instance (Record at 88-89); (2) when the validity of the cancellation was questioned by the claimants’ attorney, Nationwide never made any attempt to obtain the original premium finance agreement from the finance company (id. at 103-04, 214, 219); and (3) Nationwide, at all times, had the finance premium endorsement in its possession which showed that only Nationwide could cancel. Id. at 292. The inference is that, after assuming Porter’s defense, Nationwide found the finance company’s notice of cancellation on file. After the claimants’ lawyer had informed Nationwide that the cancellation was ineffective, Nationwide apparently “desire[d] to disentangle itself from a serious litigation, figuring perhaps in a cynical way that it had nothing to lose and at worst that it would only forfeit the policy limits.” 37 App. Div. 2d at 271, 323 N.Y.S.2d at 556.

Although the facts leading to an apparent cancellation are relevant to the issue

37
RECENT DEVELOPMENTS

judgment against the insured in excess of the policy limits,\(^3\) (3) failure
to advise the insured of the insurer's conflict of interest, the conse-
quENCES of a refusal to defend, or the danger of an excess judgment,\(^7\)
(4) failure to respond to clear offers to settle within the policy limits,\(^3\)
and (5) failure to afford the insured the customary protections provided
in the industry.\(^9\) By relying entirely on a standard of bad faith which
requires “extraordinary” or “dishonest” action and emphasizing Na-
tionwide's early withdrawal from the action,\(^4\) the majority in *Gordon*
avoided weighing these factors.\(^4\) *Gordon* thus places on the insured the
burden of showing the equivalent of fraud or intent to harm in order to
recover.\(^4\)

Such a stringent evidentiary standard is inappropriate for several

of the insurer's bad faith, they should not relieve the insurer of the duty to investigate
such facts and the legal effectiveness of a cancellation, especially when it is on notice of a
defect, as in *Gordon*. See Blakely v. American Employers' Ins. Co., 424 F.2d 728 (5th Cir.

\(^3\) See note 27 supra. See also Young v. American Cas. Co., 416 F.2d 906 (2d Cir.
1969); Landie v. Century Indem. Co., 390 S.W.2d 558 (Mo. App. 1965); Tyler v. Grange
26 Wis. 2d 306, 182 N.W.2d 493 (1965); Long §§ 5.01, 5.15.

\(^7\) See note 14 supra. See also Ging v. American Liberty Ins. Co., 423 F.2d 115 (5th
Cir. 1970); Young v. American Cas. Co., 416 F.2d 906 (2d Cir. 1969); Bollinger v. Nuss,
La. 105, 194 So. 2d 713 (1967); Lange v. Fidelity & Cas. Co., 290 Minn. 61, 185 N.W.2d
881 (1971).

\(^9\) See text accompanying note 13 supra. See also Foundation Reserve Ins. Co. v.
Kelly, 888 F.2d 528 (10th Cir. 1988); Communale v. Traders & Gen. Ins. Co., 50 Cal. 2d
654, 328 P.2d 198 (1958).

\(^3\) See text following note 15 supra. See also Seward v. State Farm Mut. Auto. Ins.
Co., 392 F.2d 722, 727 (5th Cir. 1968).

\(^4\) See 30 N.Y.2d at 437, 285 N.E.2d at 854, 334 N.Y.S.2d at 609; note 27 and accom-
panying text supra.

\(^4\) The majority opinion equivocates on this point. Judge Bergan acknowledges a
"totality of circumstances" approach at the outset: "[T]he question of breach by Nation-
wide of its good faith obligation to perform its contract of coverage cannot be walled
off from the actualities in the chain of events which Porter set in motion . . . ." 30
N.Y.2d at 438, 285 N.E.2d at 851, 334 N.Y.S.2d at 605. Later, however, the question
of refusal to defend is severed from the question of failure to consider settlement offers,
After holding that a bad faith failure to settle could not possibly be inferred because
of the early and indecisive stage of litigation, the majority focused solely on the factors
underlying Nationwide's belief that the policy had been cancelled. Somewhat inconsist-
ently, the court looked at Porter's conduct in toto in assessing Nationwide's bad faith.
Id. at 436-38, 285 N.E.2d at 853, 334 N.Y.S.2d at 607.

\(^4\) The majority opinion clearly states that the evidence is insufficient to support a
factual finding of bad faith. Id. at 433, 285 N.E.2d at 852, 334 N.Y.S.2d at 605. Chief
Judge Fuld, in his brief concurring opinion, apparently goes further, noting "that the
record before us is devoid of any evidence that defendant Nationwide acted in bad faith.
Id. at 439, 285 N.E.2d at 856, 334 N.Y.S.2d at 611 (emphasis added).
reasons. The insurance company holds itself out as an expert in the handling of personal liability suits. It markets this professional skill in exchange for the policyholder's business. Therefore, the insurer's conduct vis-à-vis its insured should be tested against a standard of what may reasonably be expected of a skilled professional. Furthermore, the insured relies on his insurer to protect his interests. Protection of this reliance interest may require affirmative conduct by the insurer as well as merely prohibiting intentional harm. Any fear that adoption of this higher standard would relieve the insured of all responsibility for claims against him is unfounded. Since the insured must comply with the requirements of the cooperation clause, his conduct would be relevant in determining the insurer's bad faith. Finally, less drastic alternatives than abandonment of its insured or immediate settlement exist for the insurer who reasonably disputes policy coverage. Litigation of the tort action may be suspended pending resolution of the dispute.

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The majority in Gordon emphasized that the insurer had relied not on its own professional skill but on the advice of legal counsel in refusing to defend. 30 N.Y.2d at 433, 285 N.E.2d at 851, 334 N.Y.S.2d at 605. This emphasis is suspect factually and legally. The plaintiff's counsel established at trial that Nationwide's attorneys were merely echoing a decision made by Nationwide's underwriting department that Porter's policy had been cancelled. Record at 178, 211-13. In Blakely v. American Employers' Ins. Co., 424 F.2d 728, 734 (5th Cir. 1970), the court stated:

In spite of American's outright promise to defend, the insurer now seeks to avoid responsibility for damages sustained by the assured by relegateing its responsibility over to legal counsel as someone akin to an independent contractor. Those whom the insurer selects to execute its promises . . . are its agents . . . ."


The Gordon majority emphasized the insured's indifference to the claims based on his negligence after Nationwide had withdrawn from the case. Judge Bergan noted three specific deficiencies: the failure to demand a settlement, the failure to obtain independent counsel, and the failure to attend the hearings after personal service of notice. 30 N.Y.2d at 435-36, 285 N.E.2d at 853, 334 N.Y.S.2d at 607. The general rule, however, is that an unjustified refusal to defend relieves the insured of certain contractual obligations (e.g., the duty to cooperate), and constitutes a waiver of any possible defense of the insurer based on the insured's noncompliance with policy conditions. See Cardinal v. State, 304 N.Y. 400, 107 N.E.2d 569, cert. denied, 345 U.S. 918 (1953); Annot., 49 A.L.R.2d 694 (1956). It seems inequitable for the insurer to be able to shift his contractual duties to the insured by wrongfully refusing to defend or to consider settlement. Cf. Gedeon v. State Farm Mut. Auto. Ins. Co., 342 F.2d 15 (D.C. Cir. 1965), on remand, 261 F. Supp. 122 (W.D. Pa. 1966).
over coverage in a declaratory judgment action. Moreover, an insurer with an honest doubt as to the merits of the claim may decline to settle and proceed to defend, reserving the right to deny coverage in a non-waiver agreement. Either of these alternatives keeps the insurer in the case, enhancing the possibility of an ultimate settlement. The Gordon decision, however, may, in effect, encourage the insurer to abandon its insured.

III

DETERMINATION OF DAMAGES IN EXCESS OF POLICY LIMITS

The Gordon majority dismissed the plaintiff's claim for failure to produce sufficient evidence of bad faith. The majority did not reach the questions of what proof of damage is required to support a prima facie case of liability, and, correlatively, what procedures and rules should be employed in awarding damages, as well as whether the insured should be required to mitigate his damages. The concurring and dissenting opinions did discuss these issues, however, and the future use of dicta appearing in those opinions as persuasive authority should not be overlooked.

46 The initiation of a declaratory judgment action to determine the insurer's obligations under the policy will ordinarily be a safe alternative for the insurer when coverage or cancellation is disputed because a declaration of no coverage terminates its obligation to defend. See General Ins. Co. v. Whitmore, 235 Cal. App. 2d 670, 45 Cal. Rptr. 556 (1965); Grilley v. Allstate Ins. Co., 50 Misc. 2d 1028, 271 N.Y.S.2d 484 (Sup. Ct. 1966); Appleman § 4686. But see Western Cas. & Sur. Co. v. Herman, 406 F.2d 121 (8th Cir. 1968) (insurer held liable for excess default judgment even though refusal to defend based on pending declaratory judgment proceeding).

47 New York allows an insurer to undertake a defense under a nonwaiver agreement or a notice of reservation of its rights accepted by its insured. This undertaking will not later estop the insurer from setting up policy defenses (e.g., no coverage or cancellation). See O'Dowd v. American Sur. Co., 5 N.Y.2d 347, 855, 144 N.E.2d 859, 863, 165 N.Y.S.2d 498, 463 (1957). The effectiveness of a reservation of rights depends, of course, on the insured's consent to the reservation, either express or implied acquiescence. Continuation of the defense when the insured either objects to or is unaware of the reservation of the insurer's rights may estop the insurer from later asserting its policy defenses. See Miller v. Union Indem. Co., 209 App. Div. 455, 204 N.Y.S. 730 (4th Dep't 1924).

Although Nationwide had assumed the defense of the action in Gordon and later withdrew, the plaintiff did not argue that the insurer had waived its right to assert cancellation. The majority opinion noted that the prejudice to the insured required for estoppel had not resulted from the insurer's withdrawal. 30 N.Y.2d at 434-35, 285 N.E.2d at 853, 334 N.Y.S.2d at 607.

48 Only the dissenting judge considered the duty to minimize damages. The majority's emphasis on Porter's indifference to the negligence action against him (see note 45 supra) indicates its implicit approval of such a duty.
A. Techniques for Measuring Compensatory Damage

Chief Judge Fuld, concurring, and Judge Breitel, dissenting, agreed that any recovery above the policy limits for the insurer's bad faith was compensatory for the actual damage incurred by the insured.49 When the insured has actually paid a judgment in excess of the policy limits or is financially able to do so, the excess judgment accurately measures the actual harm suffered by the policyholder. When the insured is insolvent or impecunious, however, as in Gordon,60 the deter-

49 In discussing the insurer's purported liability, the majority considered a recovery in excess of the policy limits by the insured's receiver to be punitive in nature. See 30 N.Y.2d at 437, 285 N.E.2d at 854, 334 N.Y.S.2d at 608; note 25 and accompanying text supra. The general rule in New York, however, is that damages for breach of contract are compensatory, and exemplary damages are not to be awarded. 1 B. Clark, New York Law of Damages § 76 (1925) [hereinafter cited as Clark]. In tort actions, the general rule requires "actual malice on the part of the defendant, or wantonness or recklessness from which such malice may be inferred" for a jury award of punitive damages. Id. § 51, at 93. Both the trial and intermediate courts in Gordon agreed that no such malice had been shown. 37 App. Div. 2d at 269-70, 323 N.Y.S.2d at 555-56; 62 Misc. 2d at 695-96, 309 N.Y.S.2d at 426-27.

It is well settled that punitive and compensatory damage awards differ in nature and purpose. Punitive damages serve to punish the particular defendant and to deter him and others from doing the wrongful act; compensatory damages serve only to indemnify the plaintiff for the actual loss suffered. See Clark § 5. The critical factor in determining which damage concept to apply is the defendant's mental state, not the nature or extent of the plaintiff's harm. For example, when an insured is impecunious, as in Gordon, an award equal to the amount by which the judgment exceeded the policy limits for the insurer's bad faith in handling a claim may far exceed any actual harm to the insured. Although such an award appears to be punitive in effect, i.e., the insurer has to pay more than the law requires, this should not lead to the conclusion that the award is punitive in theory unless the insurer's conduct was shown to deserve punishment. Furthermore, although compensatory awards may deter the defendant and others from conduct leading to legal liability (particularly in the insurance industry which is generally well apprised of the law), this effect should not lead to the conclusion that such awards are punitive in theory unless the defendant's action was maliciously motivated.

Finally, no court has awarded damages in excess of the policy limits for an insurer's bad faith refusal to defend and consider settlement on the theory that such damages are punitive. And it is doubtful that there is any basis in New York law, other than the majority opinion in Gordon, to support such a conclusion.

The law of New York requires proof of actual loss to support recovery for a tort of this type. The purpose of tort damages is to compensate an injured person for loss suffered and only for that. The law attempts to put the plaintiff in a position as nearly as possible equivalent to his position before the tort. Recovery is permitted not in order to penalize the tortfeasor, but only to give damages "precisely commensurate with the injury."


60 Porter's absence throughout the litigation left his economic status in some doubt. One justice in the appellate division summarized the available evidence as follows:

The record shows that Porter is a gas station attendant, living in a basement apartment in a low-cost area, and his car was an eight-year-old sedan worth at


imization of his actual harm is considerably more speculative. In the latter situation, both judges would reject the more popular rule that the excess judgment measures the insured's damages as a matter of law.

The opinions diverge on the significance attributable to the mere existence of an excess judgment. Chief Judge Fuld considered an uncollectible judgment harmless to the insured. Under this approach, the impecunious insured must prove actual economic harm from the

most several hundred dollars. [The injured parties' counsel] were unable to collect from Porter any part of the judgments obtained against him.

In view of these facts, it seems clear that Porter was a de facto bankrupt at the times of the accident and the entry of judgments against him. 37 App. Div. 2d at 273, 323 N.Y.S.2d at 558-59 (Benjamin, J., dissenting).

Judge Breitel would have allowed a broader consideration of potential economic harm than Chief Judge Fuld:

The factors would include the age, economic status, economic prospects, skills, health, and any other matters presently existing which would be reasonably predictive of the insured's economic future, or that of his estate, if it were likely to receive assets or benefactions.


This was the rule applied by the trial court (62 Misc. 2d at 692, 309 N.Y.S.2d at 423) and affirmed by the appellate division. 37 App. Div. 2d at 270-71, 323 N.Y.S.2d at 556. Both courts followed Henegan v. Merchants Mut. Ins. Co., 31 App. Div. 2d 12, 13, 294 N.Y.S.2d 547, 548 (Ist Dep't 1968) where it was stated that an insured is damaged, that he has suffered a loss or injury, upon entry of the excess final judgment in the damage suit case. Reason as well as economic fact dictates that the mere existence of an excess judgment causes harm to the judgment debtor.


Measuring the insured's damages as a matter of law by the excess tort judgment rests on two policy considerations: (1) an insurer, having acted in bad faith, should not benefit simply because its insured happened to be poor, and (2) an insurer should be deterred from being less responsive in its good faith obligation towards impoverished insureds than in handling claims when the insured is capable of paying an excess judgment. See Gray v. Nationwide Mut. Ins. Co., 422 Pa. 500, 223 A.2d 8 (1966). Measuring damage by the excess judgment also provides uniformity and certainty when the insured is insolvent and ascertainment of actual damage is necessarily speculative. The law of damages generally requires, however, that the harm itself be determined with reasonable certainty, even though the means of damage assessment may be imprecise. See Clark § 79. The certainty required by the majority rule frustrates this principle when, as in Gordon, the excess judgment is grossly disproportionate to any conceivable harm to the insured. Although such a rule may ensure predictable results, it does provide the insured with a recovery that will compensate his actual loss.

30 N.Y.2d at 440, 285 N.E.2d at 856, 334 N.Y.S.2d at 611.
excess judgment, such as impairment of his assets, reputation, or credit rating, to avoid dismissal.\textsuperscript{54}

Judge Breitel, on the other hand, would hold that the insured's proof of an excess judgment alone constitutes a prima facie showing of actual damage.\textsuperscript{55} This rationale places the burden of producing evidence that the insured has suffered no present or future economic harm squarely on the insurer. Thus, under Judge Breitel's approach, if the plaintiff's case on the bad faith issue is sound, the plaintiff would be certain of jury consideration of his claim for damages,\textsuperscript{56} and the risk of dismissal for failure to prove actual damages, inherent in Chief Judge Fuld's approach, would be avoided. Moreover, jury assessment of damages against the insurance company may temper the harshness of the majority rule when the large tort judgment against the insured was entered by default or against a pro forma defense.\textsuperscript{57}

B. Mitigation of Harm by the Insured

Judge Breitel's dissenting opinion also suggests that the insured may have an obligation to minimize the damages resulting from the insurer's breach by retaining his own counsel to defend the personal injury suits.\textsuperscript{58} The judge concluded, however, that Nationwide had not shown at trial that the damages could have been reduced by Porter.\textsuperscript{59}

\textsuperscript{54} Id. at 441, 285 N.E.2d at 856, 334 N.Y.S.2d at 611. Chief Judge Fuld did not clarify, however, whether such additional evidence of harm would permit jury assessment of damages or would merely allow the trial judge to instruct the jury that the excess judgment is the measure of damages.

\textsuperscript{55} Id. at 452, 285 N.E.2d at 863, 334 N.Y.S.2d at 622.

\textsuperscript{56} Id. at 451, 285 N.E.2d at 863, 334 N.Y.S.2d at 621.


\textsuperscript{58} 30 N.Y.2d at 452-53, 285 N.E.2d at 863-64, 334 N.Y.S.2d at 622.

\textsuperscript{59} Id. Judge Breitel noted that Nationwide had not shown whether Porter was financially capable of retaining independent counsel or whether the tort judgment would have been reduced if he had. \textit{Id.} Judge Breitel added, however, that the trial court erred in refusing to charge on Porter's contributory negligence. \textit{Id.} This conclusion erroneously assumed that Porter had a \textit{duty} to undertake a defense of the claim \textit{after} Nationwide's breach.

Professor Charles McCormick points out that contributory negligence is generally distinct from the duty to minimize damages:

The contributory negligence rule finds application . . . at an earlier stage in the transaction than the rule of avoidable conservation [duty to minimize damages]. If the plaintiff by negligent action or inaction before the defendant's wrongdoing has been completed has contributed to cause actual invasion of plaintiff's person or property the plaintiff is wholly barred of any relief. The doctrine of avoidable consequences comes into play at a later stage. Where the defendant has already committed an actionable wrong, whether tort or breach of contract, then this doctrine limits the plaintiff's recovery by disallowing only those items of damages which could reasonably have been averted.

\textsc{McCormick, Law of Damages} § 33, at 128-29 (1935) (footnotes omitted, emphasis in original). Judge Breitel's mislabeling of the doctrine disallowing avoidable damages as
No court has held that the insured has such an obligation to mitigate damages, and the authorities that do favor such a rule would require that for the rule to operate the insured must be financially able to retain counsel.

New York has never required insureds to retain counsel as a matter of law, even when they are financially able to do so. Nonetheless, the general rule that an injured plaintiff must take reasonable precautions to minimize damages caused by the defendant would seem to impose such a requirement. If such precautions are not taken, the plaintiff would be precluded from recovering damages by the amount that they could have been diminished. This rule would allow the insured considerable discretion in his course of action. Only reasonable precautions would be required and the insured's conduct would be judged by what a reasonable man would do under similar circumstances. The contributory negligence can only add confusion to an already unsettled area of insurance law.


In the few cases considering the question, the majority of courts have concluded that, although the insured may retain his own counsel to defend, he is not required to do so. *Compare Western Cas. & Sur. Co. v. Herman*, 405 F.2d 121, 124 (8th Cir. 1968); *In re Int'l Re-Ins. Corp.*, 29 Del. Ch. 34, 78-79 (Ch. 1946); *Carthage Stone Co. v. Travelers' Ins. Co.*, 274 Mo. 537, 201 S.W. 870 (1918), with *Fidelity & Cas. Co. v. Gault*, 196 F.2d 329 (5th Cir. 1952).

See generally *LONG § 5.23; Keeton, supra* note 5, at 1153-67.

A related question is whether the insured must attempt to reduce damages by negotiating a settlement with the injured parties on his own. The above authorities would require that the insured be financially able to pay any such settlement.

See *CLARK § 106; C. McCormick, supra* note 59, at § 33. The rule applies to tort and breach of contract actions.

We must not in the application of the [mitigation of damages] ... doctrine lose sight of the fact that it is always a conceded wrongdoer who seeks its protection. Obviously there must be strict limits to the doctrine. A wide latitude of discretion must be allowed to the person who by another's wrong has been forced into a predicament where he is faced with a probability of injury or loss. Only the conduct of a reasonable man is required of him. ... Sometimes a reasonable man might consider that either active efforts to avoid damages or a passive awaiting of developments are equally reasonable courses.
insurer would clearly bear the burden of proving that the insured's conduct was unreasonable and that damages could have been reduced.\textsuperscript{64}

**CONCLUSION**

The sharp split of opinion in Gordon undercuts the precedential value of the decision. However, the majority opinion, while open to criticism and contrary to the weight of authority, is presently the law and as such defines numerous limitations on an insured's recovery in excess of policy limits.

Subject to a decision by the Court of Appeals which reconsiders the underlying rationale of the insurer's liability for refusal to defend and settle, the insured or his representative will be forced to overcome several hurdles. First, since damages for breach of the implied covenant of good faith in insurance contracts are punitive in nature, an "extraordinary showing of bad faith" is required to establish the insurer's liability.\textsuperscript{65} Second, in addition to evidence of the insurer's failure to investigate the validity of its refusal to defend, evidence of the insurer's failure to investigate the insured's potential liability, failure to fully and accurately inform the insured, and failure to respond to a continuing offer to settle within the policy limits will also be required to permit jury consideration of the insurer's bad faith.\textsuperscript{66} Third, bad faith must be proved at "early and indefisive" stages of litigation, a difficult if not impossible burden for the insured.\textsuperscript{67}

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\textsuperscript{65} See notes 14 & 43 and accompanying text supra.

The right to reimbursement for the cost of an independent defense or a reasonable settlement is correlative to the duty to mitigate. If the insured is unable to recover reasonable expenses in minimizing his loss, he should be under no obligation to mitigate. New York has recognized this exception to the duty to mitigate when the insurer wrongfully refuses to defend on the theory that the insurer's breach of contract releases the insured from his contractual promises to cooperate and to submit to the insurer's control of the claim. See Cardinal v. State, 304 N.Y. 400, 107 N.E.2d 569 (1952), cert. denied, 345 U.S. 918 (1953); Goldberg v. Lumber Mut. Cas. Ins. Co., 297 N.Y. 148, 77 N.E.2d 131 (1948); Lindstrom v. Queen Ins. Co., 12 App. Div. 2d 813, 209 N.Y.S.2d 923 (2d Dep't 1961). This rationale should also apply to a bad faith refusal to defend and settle. See 30 N.Y.2d at 453, 285 N.E.2d at 864, 334 N.Y.S.2d at 662 (Breitel, J., dissenting); CLARK § 111.

\textsuperscript{64} See 30 N.Y.2d at 453, 285 N.E.2d at 864, 334 N.Y.S.2d at 662 (Breitel, J., dissenting); CLARK § 111.

\textsuperscript{65} See notes 25-28 and accompanying text supra.

\textsuperscript{66} See notes 35-41 and accompanying text supra.

\textsuperscript{67} See note 27 and accompanying text supra.