

MANEUVERING BETWEEN A ROCK, A HARD PLACE AND REAL TROUBLE — THE COMPETING AND CONFLICTING DUTIES, RISKS AND LIABILITIES OF A PRIMARY FIDELITY INSURER FACED WITH A LARGE LOSS CLAIM

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I. INTRODUCTION

Most insurance claims professionals are well aware of the common law, statutory, contractual and regulatory duties of good faith owed by an insurer to its insured in considering its insured's claims. The literature discussing this subject is extensive.¹ Generally the larger the claim, the more keenly aware the insured and insurer will be of these duties. Claims large enough to exceed the amount of coverage available under a primary insurer's coverage will raise yet another dynamic which the primary carrier should consider if the insured has an excess policy — the interests of the excess carrier.²

It is often broadly stated that a primary insurer owes duties of good faith and fair dealing to an excess insurer concerning the handling of claims in excess of the primary policy. It is one of the purposes of this article to consider whether in fact a primary fidelity bond insurer does, or should owe any duties to an excess insurer, in the case of a potentially covered fidelity claim

1. See, e.g., *Insurer's Breach of Covenant of Good Faith and Fair Dealing - First-Party Claims*, 31 PROOF OF FACTS (2d), 323 (1982), and the cases cited therein.

2. For the purposes of this article, "excess insurance" is defined as insurance for which the carrier is liable only for the amount of loss to the insured in excess of coverage provided the insured by another policy or policies of insurance. "Primary insurance" is defined as insurance for which the carrier is principally liable for losses to the insured up to the limits of the policy coverage.

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in excess of the primary policy, and to determine the source of those duties. Additionally, this article addresses the issue of when, if at all, a fidelity carrier can be said to be guilty of actionable “bad faith” relative to the excess carrier.

II. DUTY? I DON'T SEE A DUTY. DO YOU SEE A DUTY?

It would be logical for any inquiry into the duties owed by a primary insurer to an excess insurer to begin with the insurance contracts themselves. Unfortunately, the policies are usually silent on such issues, which should not be surprising, inasmuch as the excess and primary insurers do not have contracts with each other, their respective contracts are only with their mutual insured.³

Given the existence of numerous insurance trade associations, and the fact that a company may be an excess insurer in some instances and an underlying insurer in others, it would also seem logical to look for intercompany agreements which would provide guidance to both excess and primary carriers as to their respective duties and reasonable expectations. Surely, an industry accustomed to drafting detailed insuring agreement forms which precisely limit and define an insurer's obligations would not leave its members to abide by unwritten, esoteric and abstract duties, or even worse, judicially fashioned obligations to each other?

Indeed, the industry attempted to reach agreement on these issues in 1974, when the Claim Executive Council of the American Insurance Association, the American Mutual Insurance Alliance, and some unaffiliated insurers drafted recommended “Guiding Principles for Primary and Excess Insurers” for the purpose of providing standards of conduct between primary and excess insurers concerning settlement and trial decisions.⁴

However, many of the original signatories to these Guiding Principles have withdrawn.⁵ Some may have come to disagree with the provisions, others may have realized that the intervening enactment of fair claim handling statutes in some respects superseded the Principles, as has subsequent

3. By contrast, the relationship between a reinsured insurer and its reinsurer is, in the first instance, contractual. Hence, courts have found that the ceding insurer (the reinsured) owes its reinsurer a direct duty of utmost good faith. *Sumitomo Marine Fire Ins. Co., Ltd. v. Cologne Reinsurance Co. of America*, 75 N.Y.2d 295, 303, 552 N.E.2d 139, 143 (1990).

4. *See International Ins. Co. v. Dresser Industries, Inc.*, 841 S.W.2d 437, 441-42 (Tex. Ct. App. 1992), for a restatement of the Guiding Principles.

5. James A. McGuire, *Bad Faith, Excess Liability and Extracontractual Damages: Counsel for the Excess Carrier Looks at the Issues*, 72 U. Det. Mercy L. R. 49, 79 (1994); SHAUN MCPARLAND BALDWIN AND DAWN MIDKIFF, PRIMARY AND EXCESS RELATIONSHIPS: EXAMINING THE EVOLVING DUTIES, THE RIGHTS AND DUTIES OF PRIMARY AND EXCESS INSURANCE CARRIERS 39 (1993).

case law. Carriers should be cautioned, however, that it may make no court has “found” “that the [Guiding P]rinciples set forth the general standards of industry practice,”⁶ while another “employ[ed] the Principles as an indication of a practice or a goal of the insurance industry.”⁷ Both courts then applied the Guiding Principles to assess the propriety of actions by non-signatories.

In any event, however, the Guiding Principles are of somewhat limited assistance in answering the questions posed in this article, because they expressly apply to the investigation, settlement and defense of third party liability claims, rather than the handling of first party indemnity claims, and do not address several of the issues considered herein.⁸ However, the absence of any industry-wide agreements and direct contracts between insurers on the same risk has not slowed the courts in their rush to create obligations where they are not otherwise defined.⁹ As a result, the primary source for resolution of the issues to be addressed in this article is case law in which insurers, as adversaries, have asked the courts to create and define their relationships, for good or ill.

III. LIABILITY INSURANCE: DUTIES, DUTIES EVERYWHERE!

Judicial recognition of the need for a primary insurer to be mindful of the existence of — let alone duties owed to — an excess insurer developed originally within the context of liability insurance claims. It is instructive to review the development of the case law in the context of liability insurance in order to be able to determine whether — and if so, why — the excess– primary insurer relationship should be different in a first party indemnity claim under the typical fidelity bond or policy.¹⁰

6. *United States Fire Ins. Co. v. Nationwide Mut. Ins. Co.*, 735 F. Supp. 1320, 1325 (E.D.N.C. 1990).

7. *Monarch Cortland v. Columbia Cas. Co.*, 165 Misc.2d 98, 626 N.Y.S.2d 426, 431 (1995).

8. It need only be briefly noted that a fidelity bond is a first party, rather than third party, insurance policy, providing indemnity to the insured for its actual losses, rather than liability insurance for third party claims. See, e.g., *Everhart v. Drake Mgt., Inc.*, 627 F.2d 686 (5th Cir. 1980); *School Employees Credit Union v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 839 F. Supp. 1477, 1480 (D. Kan. 1993).

9. As the court explained in *Am. Auto Ins. Co. v. Seaboard Sur. Co.*, 155 Cal.App.2d 192, 318 P.2d 84 (1957): “The reciprocal rights and duties of several insurers who have covered the same event do not arise out of contract, for their agreements are not with each other. Their respective obligations flow from equitable principles designed to accomplish ultimate justice and a bearing of a specific burden. As these principles do not stem from agreement between the insurers, their application is not controlled by the language of their contracts with the respective policy holders.”

10. It is outside the parameters of this article to consider whether, and if so, when a fidelity bond covers losses resulting from third party claims against the insured, based on the dishonest or fraudulent acts of its employees. See, e.g., C. David Hailey, *Legal Liability for Third Party Losses*

Originally, the issue of the primary liability insurer's potential liability to an excess liability insurer, arose within the context of permitting an excess insurer to be subrogated to its insured's rights against a primary carrier which wrongfully failed to pay a covered third party claim. It is generally held that a liability insurer must take into account the insured's interests in considering a claim in excess of the policy limits. Accordingly, the courts impose a duty on the primary insurer as part of the implied-in-law duty of good faith and fair dealing arising out of the insurance relationship to give its insured's interests consideration at least equal to that of its own.¹¹ If the insurance company instead commits conduct constituting fraud, negligence or bad faith in refusing to settle a case with policy limits, it may be liable for the full amount to a judgment obtained against its insured, irrespective of its policy limits.¹²

It is to this duty that an excess liability carrier is subrogated when compelled to pay a claim on behalf of an insured which the insured's primary insurer refused to pay. In such cases, it has long been held that the excess insurer is subrogated to the rights of the insured against the primary insurer, by virtue of general equitable principles, as well as any subrogation clause which may be contained in the excess policy.¹³ Consequently, an

Under Commercial Crime Policies (unpublished paper submitted at the A.B.A. Tort and Ins. Practice Section, Fidelity and Surety Law Committee Mid-Winter Meeting, New York, N.Y. on January 27, 1995); Bruce King, *Coverage Under Fidelity Bonds for Third Party Claims Not Involving Loss of Property*, 13 FORUM 507 (1978); Karen Wildlau, *Evolving Law of Third party Claims Under Fidelity Bonds: When is Third Party Recovery Allowed?*, 24 TORT & INS. L.J. 93 (1989). Certainly, many fidelity bonds anticipate that covered losses will result from claims by third parties, because the insured is often specifically obligated to notify the insurer of such claims. For purposes of this article, it is assumed that the insured's claim is for losses already incurred, or which it appears likely to incur, in excess of the primary policy limits, whether or not the loss to the insured results from the insured's liability to third parties.

11. The number of cases which stand for this proposition are too many to cite. See, e.g., *Peter v. Travelers Ins. Co.*, 375 F. Supp. 1347, 1349 (C.D. Cal. 1974); *Hoskins v. Aetna Life Ins. Co.*, 452 N.E.2d 1315 (Ohio 1983).

12. See, e.g., *Scroggins v. Allstate Ins. Co.*, 393 N.E.2d 718, 720 (Ill. Ct. App. 1979).

13. *Annotation, Right to Subrogation, as Against Primary Insurer, of Liability Insurer Providing Secondary Insurance*, 31 ALR2d 1324 (1953). The right of an excess insurer to recover from a primary carrier is contractual, when there are provisions in the excess policy which permit subrogation of the excess insurer to the rights of the insured. These provisions have been construed to inure to the benefit of that insurer as against other insurance companies which provide primary insurance in favor of the same insured. *Aetna Cas. & Surety Co. v. Buckeye Union Co.*, 105 N.E.2d 568 (Ohio 1952). By contrast, equitable subrogation permits a payment insurer to "step into the shoes" of the insured and pursue recovery from third parties responsible to the insured for the loss for which the insurer has been held liable and paid. *Fireman's Fund Ins. Co. v. Maryland Cas. Co.*, 26 Cal. Rptr. 2d 762, 767-68 (1994). Six essential elements have been identified as necessary to an insurer's cause of action based on equitable subrogation: (1) the insured must suffer a loss for which the party to be charged is liable, either because the latter is a wrongdoer whose act or omission caused the loss or because he is legally responsible to the insured for the loss caused by the wrongdoer; (2) the insurer, in whole or in part has compensated the insured for the same loss for which the party to be charged is liable;

excess insurer which has discharged its insured's liability may stand in the shoes of its insured, and as subrogee may maintain an action against the primary insurer if the latter negligently and in bad faith fails to settle a claim against its insured within the insured's primary policy limits.¹⁴ It is undisputed that a primary liability insurer has an obligation to its insured to settle a claim within the insured's primary policy limits when a prudent insurer without policy limits would have accepted a similar settlement offer.¹⁵ This obligation to settle may be enforced by an excess insurer as the insured's subrogee if the excess insurer pays any judgment over the primary policy limits as a result of the primary carrier's wrongful failure to settle.¹⁶ In essence, the excess carrier is given the right to recover from the primary insurer the entire judgment paid by the excess carrier, not just the amount the primary insurer failed to pay under its policy.¹⁷ Such a result is usually justified by the courts as a matter of "public policy." If the excess insurer were not allowed to obtain complete reimbursement of its payment on behalf of the insured from the primary carrier, then a primary insurer would be relieved of its duty to accept reasonable offers by the existence of excess insurance coverage, in which case, the additional financial liability on excess carriers would result in increased premiums. Further, to hold that an excess carrier has no cause of action against the primary carrier would reduce the incentive of a primary carrier to settle when a settlement offer is close to or exceeds its policy limits. Such a result would be contrary to the interests of the public in obtaining prompt and just settlement of claims.¹⁸ It has also been reasoned that if there were no excess insurer, then the primary insurer owes the insured a duty to protect him from an excess judgment and personal liability. When the insured purchases excess coverage, he is substituting the excess insurer for himself. It is therefore only fair that the excess insurer assume the rights as well as the obligations of the insured vis-à-vis that liability.

(3) the insured has an existing, assignable cause of action against the party to be charged, which action the insured could have asserted for himself if he had not been compensated for his loss by the insurer; (4) the insurer has suffered damages caused by the act or omission upon which the liability of the party to be charged depends; (5) justice requires that the loss should be entirely shifted from the insurer to the party to be charged; and (6) the insurer's damages are in a stated sum, usually the amount it has paid to its insured, assuming the payment was not voluntary and was reasonable. *Fireman's Fund Ins. Co., supra* at 768.

14. *E.g., United States Fire Ins. Co. v. Royal Ins. Co.*, 759 F.2d 306 (3d Cir. 1985).

15. *Peter v. Travelers Ins. Co.*, 375 F. Supp. 1347, 1349 (C.D. Cal. 1974).

16. *See Annotation, Duty of Liability Insurer to Settle or Compromise*, 40 ALR2d 168 (1955).

17. *Annotation, Excess Carrier's Right to Maintain Action Against Primary Liability Insurer for Wrongful Failure to Settle Claim Against Insured*, 10 ALR4th 879, 881-82 (1981).

18. *Id.* at 882-83, and see cases discussed therein.

Over the years, the courts have expanded the simple duty of an insurer to settle a covered claim within the limits of a policy to a more broadly stated duty to act as “an ordinarily prudent person in business management” and extended that duty to “claim investigation, trial defense, and settlement negotiations.”¹⁹ More generally stated, the primary insurer owes the insured a duty not to “mishandle” a claim, and under appropriate circumstances, an excess carrier has been allowed to sue the primary insurer as the insured’s subrogee for “mishandling” a claim.²⁰ In addition to failure to settle claims in good faith, “claim mishandling” may include failure to properly defend a claim.²¹ However, most fidelity claims will not implicate any duty to defend a third party claim, unless the primary insurer avails itself of the option under some policies²² to undertake the defense of the third party’s claim, thereby changing the nature of the fidelity coverage from that of an indemnity to a liability policy.

IV. THE SUBROGATION SHOES BLUES

However, when the excess insurer merely stands in the shoes of the insured, he is no better position than the insured. That is, the rights to which the subrogee succeeds are the same as, but no greater than those of the person for whom he is substituted and subject to any defenses that might have been urged against the latter.²³ Hence, if the insured failed to give notice, failed to cooperate, or otherwise acted in violation of the primary policy or in such bad faith, as to constitute a defense to any direct action it might have brought against the primary insurer, the excess insurer’s bad faith claims against the primary carrier will be barred as would the insured’s.²⁴ Ordinarily, it would appear that there should be no reason for the excess insurer to have rights against the primary insurer which would be

19. *Am. Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 482 (Tex. 1992).

20. *Id.* at 484-85.

21. *Id.* at 481; *see also Centennial Ins. Co. v. Liberty Mut. Ins. Co.*, 404 N.E.2d 759, 761 (Ohio 1980), and cases cited therein; Jane M. Draper, *Annotation, Liability Insurance: Excess Carrier’s Right of Action Against Primary Carrier for Improper or Inadequate Defense of Claim*, 49 ALR4th 304, 305 (1986). As a side note of possible concern to the insurance defense bar, the *American Centennial* case also held that the excess insurer may sue the defense counsel hired and supervised by the primary insurer.

22. General Agreement F of the Form 24 Financial Institution Bond allows the insurer the option to undertake defense of a third party claim against the insured. However, upon electing to defend the third party claim, any judgment against the insured on such claim, or settlement of those claims in which the insurer participates, will be covered.

23. 73 AM. JUR. (2d) SUBROGATION 106 (1974).

24. *Am. Centennial Ins. Co.*, 843 S.W.2d at 483; *Comm. Union Ins. Co. v. Med. Protective Co.*, 393 N.W.2d 479 (Mich 1986); *see also Puritan Ins. Co. v. Canadian Univ. Ins. Co.*, 775 F.2d 76, 78 (3d Cir. 1985).

superior to the rights of its insured. Certainly, a majority of the courts asked to address this issue have so ruled. However, a few courts have “discovered” that a direct duty of good faith and fair dealing is owed by the primary insurer to the excess insurer. These cases allow an excess insurer to sue the primary insurer for bad faith independent of any right of equitable subrogation. The cases are definitely the minority view on the issue. The authority of these decisions has been weakened by subsequent decisions, and questioned considerably, with good reason.

V. BAD FACTS MAKE WORSE LAW

The original direct duty cases involve affirmative misconduct on the part of the primary insurer, often in collusion with the insured, whereby the primary insurer minimized its own liability, and appeared to have deliberately created or increased liability for the excess carrier.

In the much discussed case of *Hartford Accident and Indemnity Co. v. Michigan Mutual Insurance Co.*,²⁵ Michigan Mutual insured three affiliated companies for general liability as well as worker’s compensation. Hartford was the excess general liability insurer. An employee of one of the companies was injured and sued the two affiliates with whom he was not employed. Michigan Mutual defended the litigation and refused the demands of Hartford that the employer be impleaded, apparently because Michigan Mutual did not want to invoke its worker’s compensation liability. When a verdict in excess of the primary coverage resulted in the litigation, Hartford paid the excess amount and sued both Michigan Mutual and its defense counsel alleging bad faith and breach of fiduciary duty owed directly to Hartford in its status as excess insurer, rather than as subrogee to the insureds. Hartford alleged that it was harmed because it was required to contribute more towards settlement of the third party judgment than it would have if the employer - and Michigan Mutual’s additional coverage under its workers’ compensation policy - had been joined in the action. The Court in Michigan Mutual allowed the suit to survive a motion to dismiss, reasoning that:

[I]t has been recognized in this and other states...that the primary carrier owes to the excess insurer the same fiduciary obligation which the primary insurer owes to its insured, namely, a duty to proceed in good faith and in the exercise of honest discretion, the violation of which exposes the primary carrier to liability beyond its policy limits.²⁶

In support of this statement, the court cited numerous cases in which the courts have recognized the insurer’s rights of equitable subrogation, and

25. 475 N.Y.S.2d 267 (1988).

26. *Id.* at 341-42.

specifically concluded that “upon payment by Hartford under its excess coverage, it became the equitable assignee or subrogee of whatever rights its assureds would have had...”²⁷ The court then, went far further than the cases upon which it relied and stated that Michigan Mutual, in undertaking sole defense of the litigation against its insured owed:

[A] primary obligation to its assured and to the excess insurer to exercise good faith in handling the defense and to safeguard the rights and interests of the excess carrier. ... Any such right of action arises as a result of the independent and direct duty to the excess insurer and is not dependent upon equitable principles of subrogation.²⁸

The court in *Michigan Mutual* devoted absolutely no discussion to its conclusion that there is an independent duty of good faith owed by a primary carrier to an excess carrier, nor can it be deduced from reading the decision whether the fiduciary duties it announced so confidently apply only to the primary carrier’s defense of third party litigation, or more broadly to all aspects of claims handling, in first party as well as third party claims. Unfortunately, the decision is frequently cited in support of arguments that primary liability carriers owe direct duties of various types to excess carriers, without regard to the type of claim or insurance involved.²⁹

Several Illinois federal district court cases have also ruled that primary insurers owe direct duties to excess carriers, as a matter of Illinois law, despite the absence of Illinois decisions to support this conclusion.³⁰ The Seventh Circuit has expressly refused to follow these decisions and, in *Twin City Fire Insurance Co. v. Country Mutual Insurance Co.*,³¹ declined to rule that Illinois law imposed direct duties of good faith upon primary carriers in favor of excess carriers.

One California court experimented with the notion that each of the three parties to what it saw as a “triangular relationship” of insured, primary and excess carrier owed duties of good faith one to another.³² But this novel doctrine of “triangular reciprocity” has not found much favor in subsequent decisions in California or elsewhere.³³

27. *Id.*

28. *Id.* at 342.

29. See, e.g., *Monarch Cortland v. Columbia Cas. Co.*, 165 Misc.2d 98, 626 N.Y.S.2d 426, 430 (1995)(finding a direct duty to notify the excess carrier of the potential for an excess claim).

30. *Ranger Ins. Co. v. Home Indem. Co.*, 714 F. Supp. 956 (N.D. Ill. 1989); *Am. Centennial Ins. Co. v. Am. Home Assur. Co.*, 729 F. Supp. 1228 (N.D. Ill. 1990).

31. 23 F.3d 1175 (1994),

32. *Transit Cas. Co. v. Spink Corp.*, 156 Cal. Rptr. 360 (Calif. Ct. App. 1979).

33. See, e.g., *Commercial Union Assur. Co. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Calif. 1980); *Fireman’s Fund Ins. Co. v. Maryland Cas. Co.*, 26 Cal. Rptr.2d 762, 771 note 13 (Calif. Ct. App. 1994) (“It appears Transit Casualty’s ‘triangular reciprocity’ approach has been at least

VI. THE MAJORITY RULE -
THE INSURED'S SHOES ARE BIG ENOUGH, THANKS!

By far the majority rule in this country permits excess liability carriers to sue primary liability carriers only on grounds of equitable subrogation, refusing to recognize the right of a direct action against the primary carrier.³⁴ Such a rule is far more consistent with the realities of the “relationship” between excess and primary carriers on any given loss. That is, there is no real relationship between them and one should not be judicially manufactured. Each has a separate contract with the insured, and none with each other. The fact that there is no contract between the excess and primary carriers, should be more than enough to defeat any argument that there are implied covenants of good faith and fair dealing directly between the two, since such covenants are implied contractual terms and have no existence separate from contract.³⁵ Nor is it correct to argue that the excess carrier is a third party beneficiary to the insured’s contract with the primary carrier.³⁶

Conflicts of interest among the two carriers often naturally arise. In a third party case, the excess carrier may wish the primary insurer would dispose of the case within its limits, and might not look favorably on a decision to gamble with a trial which may result in a large verdict.³⁷ On the other hand, an excess carrier might want the primary carrier to contest coverage or the amount of loss rather than concede both, thereby removing the major condition precedent to coverage under the excess policy. As the Seventh Circuit noted in *Twin City Fire*:

Why should [the excess insurer] also have a tort duty against the primary insurer? That would place the latter in the uncomfortable position of facing a tort suit for bad faith if it settled the case and a tort suit for bad faith if it tried the case.³⁸

impliedly overruled.”). There are several cases which appear to acknowledge a direct duty owed by a primary carrier to an excess carrier, but careful reading of the decisions reflects that the holdings actually do no more than state the fact that the excess carrier has “precisely the same status as the assured” (*Penn v. Amalgamated General Agencies*, 372 A.2d 1124 (N.J. 1977)), which is simply a restatement of the right of equitable subrogation without specifically invoking the doctrine. *Id.*; *Western World Ins. Co. v. Allstate Ins. Co.*, 376 A.2d 177 (N.J. Super. Ct. 1977).

34. See *Am. Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d 480, 482 (Tex. 1992) and cases cited therein; *Hartford Accident & Indem. Co. v. Aetna Cas. & Surety Co.*, 792 P.2d 749 (Ariz. 1990); *Hartford Cas. Ins. Co. v. New Hampshire Ins. Co.*, 417 Mass. 15, 628 N.E.2d 14 (1994); *Twin City Fire Ins. Co. v. County Mut. Ins. Co.*, 23 F.3d 1175 (7th Cir. 1994).

35. *Fireman’s Fund Ins. Co. v. Maryland Cas. Co.*, 21 Cal. App. 4th 1586, 1601, 26 Cal. Rptr. 2d 762 (1994).

36. *Id.* at 766.

37. *Puritan Ins. Co. v. Canadian Univ. Ins. Co.*, 75 F.2d 76, 78 (3d Cir. 1985).

38. *Id.* at 80.

Additionally, the obligations of the carriers are different, certainly in third party claims, where the primary insurer is responsible for both settlement and defense of the third party claims, while the excess carrier is usually responsible for neither. The excess carrier often expressly aligns itself in opposition to the primary carrier with the use of "bad faith letters".³⁹

Given such inherently different interests and roles in any given insurance claim, it is surely asking too much to impose upon the primary insurer duties to the excess insurer different from and over and above those already generous duties owed to the insured.

VII. FIRST PARTY v. THIRD PARTY CLAIMS

Cases which discuss the duties owed to excess carriers by primary carriers seldom address the issue of whether it makes a difference that the coverage is first party or third party. Perhaps that is because, in most jurisdictions, the source of the excess insurer's rights is generally stated as the duty of good faith and fair dealing owed to the insured by the primary insurer, which is commonly agreed to be implied in every insurance contract.⁴⁰

However, we need to be careful to the extent we seek to import liability insurance concepts into fidelity insurance relationships. It may be that the cases which discuss the relationships and respective duties of primary and excess liability insurers might not be a good resource for determining what duties may be owed by a primary fidelity insurer to its insured's an excess carrier. This is because the duty of an insurer to act in good faith under indemnity insurance involves different undertakings than those required of a liability insurer, in that the two types of policy impose different duties and responsibilities on the respective insurers.

For example, ordinarily, when there is a dispute between insured and insurer concerning a first party indemnity claim, it is likely to be, at heart, a coverage dispute. It is the indemnity insurer's primary obligation in such cases not to thwart in bad faith the insured's reasonable expectations under the policy. Additionally, first party claims usually do not involve defense by the insurer of a legal action against the insured, that could result in financial ruin of its insured.⁴¹ Thus the risks to the insured are less and the duties owed by a first party insurer to its insured are fewer. There are no lawsuits

39. *Id.* at 78.

40. *North American Van Lines, Inc. v. Lexington Ins. Co.*, 21 Fla. L. Weekly 1564, 1566 (Fla. App. 1996); *see also Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256, 792 P.2d 719, 723 (1990).

41. *Clearwater v. State Farm Mutual Automobile Ins. Co.*, 792 P.2d 719, 722 (Ariz. 1990).

to defend, or third party claims to settle, unless, as indicated earlier in this article, the insured elects to defend a third party claim.

Generally speaking, bad faith on the part of a first party insurer is defined in the various state unfair claims handling practices acts, and in such common law statements as a variation of the following:

Not attempting in good faith to settle claims when, under all the circumstances, it could and should have done so, at it acted fairly and honestly toward its insured and with due regard for his interests.⁴²

The primary focus in first party bad faith actions is whether the insurers failure to “promptly” settle constitute bad faith. The statutory provisions such as that just cited follow longstanding public policy and promote quick resolution of insurance claims.⁴³

The difference between third party bad faith claims and first party bad faith claims is in the nature of the harm or risk to the insured, as well as the difference in the duties undertaken by the insurer. In third party common law bad faith, the liability insurer exposes its insured (and by implication the excess carrier) to an excess judgment when the insurer could have and should have settled a claim against its insured within the policy limits.⁴⁴ In a first party bad faith claim, the insured is not injured by an excess judgment amount, the insured’s bad faith claim is simply for the amount of its loss, for which the insurer either refused timely payment or otherwise wrongfully denied coverage.⁴⁵

It follows that a primary indemnity insurer should owe different duties to the excess carrier than a primary liability insurer, especially, if the duties arise only as a result of equitable subrogation of the excess carrier to the rights of the insured. It should be kept in mind that equitable subordination is a creature of equity. In one of the early decisions on the doctrine, *Bennet v. Preferred Accident Ins. Co.*,⁴⁶ the court explained that the doctrine of subrogation “flows” from:

[P]rinciples of justice, equity, and benevolence. It is a purely equitable result, depending, like other equitable doctrines, upon the facts and circumstances of each particular case to call it forth.⁴⁷

42. 624.155 Fla Stat. (1990).

43. *Brookins v. Goodson*, 640 So.2d 110, 112 (Fla. App. 1994).

44. *Brookins*, 640 So.2d at 113.

45. See also *Clearwater v. State Farm Mutual Automobile Ins. Co.*, 792 P.2d at 723.

46. 192 F.2d 748 (10th Cir.),

47. *Id.* at 751.

Hence, an excess insurer does not “stand in the shoes” of its insured in the abstract or for all purposes, it does so only when the facts and circumstances warrant equitably subrogating the excess insurer to the insured. As noted above, there are six essential elements for an insurer to be equitably subrogated to its insured’s rights against a third party.⁴⁸ Among these is the requirement that the excess carrier must have been damaged by having to pay a loss it was not required to pay, which was supposed to have been paid by the primary insurer. Additionally, the insured must have a valid claim against the primary carrier. Finally, justice must require that the entire loss be shifted from the excess insurer to the primary. These various requirements are more easily satisfied in the liability insurance context than in the handling of fidelity claims.

The differences in the duties owed between insurers in indemnity and liability claims are perhaps most clear in the context of the primary insurer’s duty to the insured to settle the insured’s claim. Excess insurers frequently argue that primary insurers owes them duties in settlement negotiations which appear to be at odds with the duties owed the insured directly.

VIII. THE TREACHEROUS WATERS OF “GOOD FAITH” CLAIMS NEGOTIATIONS

As noted above, the primary motivation of courts in permitting suit by excess carriers against primary carriers is the desire to encourage prompt, fair and reasonable settlement of lawsuits.⁴⁹ That being the case, is it possible that a primary insurers’ good faith settlement negotiations with the insured be considered a breach of duty to or even bad faith vis-a-vis the excess insurer?

The issue arises when the insured presents a claim in excess of the primary coverage and appears willing to compromise its claim against the primary carrier by accepting less than full payment of the primary policy limits, if the excess carrier will also contribute to the settlement. The initial response of the primary insurer to such a proposal is often diametrically opposite of the excess insurer’s response which may object to even being invited by either the insured or the primary insurer to discuss such a settlement.

The initial and strongly asserted objection by the excess carrier to such a settlement proposal is the fact that it cannot be “obligated to contribute to a

48. *Fireman’s Fund Ins. Co. v. Maryland Cas. Co.*, 26 Cal. Rptr. 2d 762, 767-68 (Calif. Ct. App. 1994).

49. *Am. Centennial Ins. Co. v. Canal Ins. Co.*, 843 S.W.2d at 482.

settlement until the limit of the primary carrier's coverage has been exhausted."⁵⁰ Such an argument raises the issue of what is meant by "exhaustion" of the primary limits,⁵¹ and begs the question of whether being invited to contribute to a settlement can be said to be tantamount to "obligating" the excess carrier, as opposed to allowing it to participate in a multiparty settlement. Additionally, it strains the definition of "bad faith," which:

[A]lthough not susceptible of concrete definition, embraces more than bad judgment or negligence. It imports a dishonest purpose, moral obliquity, conscious wrongdoing, breach of a known duty through some ulterior motive or ill will partaking of the nature of fraud. It also embraces actual intent to mislead or deceive another.⁵²

As long as the primary insurer is acting honestly and openly in an effort to discharge its duties to its insured, how can it be said to be in bad faith under such a definition?

Not too surprisingly, an excess insurer's unwavering determination to stand on the exhaustion provisions of its policy at the risk of interfering with the court's overriding interest in settlement of claims is not one favored by the courts. In *Centennial Ins. Co. v. Liberty Mutual Insurance Co.*,⁵³ an excess insurer sued the primary carrier for alleged "bad faith" negotiations which consisted of the primary carrier twice contacting the excess carrier to advise that the primary carrier was deadlocked in its claims settlement negotiations, and asking if the excess carrier would contribute a relatively small amount to account for the difference in the parties settlement positions. Both times, the excess carrier declined, insisting that the primary carrier had to exhaust its limits before even requesting contribution. In ruling that the primary carrier's requests for participation in the settlement did not constitute improper activity, the court followed the holdings of other cases, and ruled:

[T]here is nothing per se improper in the bare mention by the insurer that contribution is possible. Any impropriety would seem to arise from insistence upon a contribution as the price of settlement, particularly where the amount demanded is relatively high compared with what the insurer is willing to contribute.⁵⁴

50. *Valentine v. Aetna Ins. Co.*, 564 F.2d 292, 296 (9th Cir. 1977).

51. In *Stargatt v. Fidelity and Cas. Co. of N.Y.*, 76 F.R.D. 689, 690 (D. Del. 1975), the court ruled that the primary policy would be "exhausted" for purposes of reaching the excess policy by a settlement, pursuant to which the primary insurer actually paid less than its policy limits. See further discussion of this issue below.

52. 404 N.E.2d at 762.

53. 404 N.E.2d 759 (Ohio 1980).

54. *Id.* at 25-26, citing *Brockstein v. Nationwide Mut Ins.*, 417 F.2d 703, 709 (2d Cir. 1969).

Nor would such an invitation to negotiate be expressly barred even by the Guidelines as drawn by the industry well before the nationwide enactment of the claims handling statutes. Guideline No. 5 states, "If at any time, it should reasonably appear that the insured may be exposed beyond the primary limit, the primary insurer shall.... invit[e] the excess insurer to participate in a common effort to dispose of the claim. Guideline No. 7 is significant in what it does not prohibit. It states: The primary insurer shall never seek a contribution to a settlement within its policy limit from the excess insurer.⁵⁵ It may, however accept contribution to a settlement within its policy limit from the excess insurer when such contribution is voluntarily offered."

Clearly, these Guidelines at least impliedly, allow the primary insurer to "invite" the excess insurer to "participate in a common effort to dispose of the claim" and to indicate its willingness to accept a contribution to a settlement in excess of its policy limits. Such a result makes sense. On one hand, if the loss truly is excess of the primary policy, but the insured is willing to accept payment of less than full value of the claim, why should the excess carrier reap the sole benefit of the compromise? Why should the courts look with favor on the excess carrier's refusal to settle a significant claim just because of a provision in the excess policy that its coverage is not triggered unless the primary coverage is "exhausted." Absent compromise by all concerned as to payment of the amount claimed by the insured, both carriers would risk paying more than their share of the settlement amount, and the courts would have another unnecessary lawsuit to resolve. Additionally, if the insured is in agreement as to the settlement, how can it be argued that a primary carrier acted in "bad faith negotiations" in inviting an excess insurer to contribute to a settlement in a total amount in excess of the primary coverage, but to which the primary insurer did not intend to contribute all of its policy limits. This would certainly not be bad faith as to the insured. Absent fraud or collusion by the insured and insurer, it would seem impossible that the primary insurer can be said to have acted in bad faith as to the excess carrier if its actions in all respects are in good faith as to its insured, since the excess insurer has no better position than its insured.

The likely displeasure of a court with an objection raised by an excess carrier with such settlement negotiations, is additionally evidenced by several decisions concerning litigation between excess and primary insurers over settlement effected by the primary carrier, without the excess carrier's involvement, in which the claim was settled for less than full amount of the primary coverage, but the insured agreed that the primary carrier could pay

55. It has been observed that it may be evidence of bad faith for an insurer to attempt to induce the insured to contribute to the amount needed to effect a settlement within the policy limits. *See* cases discussed at 40 ALR2d, at 12.

less than its full policy limits. The issue for the courts' determination was whether a partial settlement of a claim for less than the primary carrier's limit would constitute 'exhaustion' of the limit, for purpose of triggering an excess insurer's indemnity obligation. The answer to this issue depends in part on the terms of the agreement, and whether the jurisdiction recognizes any direct duties owed by the primary insurer to the excess insurer. If the jurisdiction does not recognize a direct duty, and the agreement is otherwise fair, then the overriding interest of the courts to encourage settlement, and the usual determination that no actual harm results to the excess insurer, would likely result in such settlements being approved.

The "seminal" case on this issue is *Zeig v. Massachusetts Bonding & Insurance Co.*,⁵⁶ In *Zeig*, the insured had a burglary loss and made first party claims against its primary and excess insurers. He had \$15,000 in primary coverage and \$5,000 in excess coverage. He settled with his primary insurers (he had more than one primary policy) for a total of \$6,000 and then sought recovery against his excess carrier for the amount of his loss in excess of \$15,000. The excess carrier argued that its liability could not be triggered by the settlement of the primary carriers' liability, for less than full policy limits and in support of its argument relied upon its policy provision which provided for coverage "only after all other insurance herein referred to shall have been exhausted in the payment of claims to the full amount of the expressed limits of such other insurance."⁵⁷ The Second Circuit was unconvinced, and found the excess insurer's interpretation of its policy as "unnecessarily stringent."⁵⁸ Although seeming to agree that an excess insurer might condition its liability on actual cash payment of underlying policy limits in full, the court, found no such condition in the excess policy before it:

Nothing is said about the "collection" of the full amount of the primary insurance. ...the claims are *paid* to the full amount of the policies, if they are *settled* and *discharged*, and the primary insurance is *thereby exhausted*. There is no need of interpreting the word payment as only relating to payment in cash. It often is used as meaning the satisfaction of a claim by compromise, or in other ways.⁵⁹

In a statement frequently quoted by primary insurers in later cases, the court in *Zeig* made clear its assessment of the interests of the parties and public policy concerning such settlements:

56. 23 F.2d 665 (2d Cir. 1928).

57. The language in modern day excess policies is quite similar. The standard excess comprehensive dishonesty, disappearance and destruction policy provides coverage "only in excess of and after all the Underlying Insurance...has been exhausted."

58. *Id.* at 666.

59. *Id.* (emphasis added.)

[The excess insurer] had no rational interest in whether the insured collected the full amount of the primary policies, so long as it was only called upon to pay such portion of the loss as was in excess of the limits of those policies. . . to require an absolute collection of the primary insurance to its full limit would in many, if not most, cases involve delay, promote litigation, and prevent an adjustment of the disputes which is both convenient and commendable. A result harmful to the insured, and of no rational advantage to the insurer, ought only to be reached when the terms of the contract demand it.⁶⁰

It might not be coincidental that *Zeig* involves first party coverage. At least one other commentator has noted that the court's reasoning might not be easily imported into cases dealing with third-party liability coverage.⁶¹ Similarly, in *Federal Insurance Co. v. Srivastava*,⁶² the court exonerated the excess carrier from liability because its insured deliberately abandoned an appeal when the excess carrier refused to participate in the settlement of a case in which the primary insurers had not actually paid the full amount of their respective policy limits.⁶³

Nevertheless, a number of courts have either followed *Zeig* or reached similar results in third-party cases.⁶⁴ The reasoning of these courts is best typified by the following statement by a New Jersey court:

Meaningless technicalities aside, the public interest points towards resolution of the competing interests to permit Plaintiff to settle claims against the assets of two of the three exposed entities [the insured and its primary insurer] without releasing the third....Insurance of course, is an instrument of social policy...Since a carrier has a duty to act in good faith where its interests conflict with those of the insured in connection with settlement negotiations, it certainly cannot complain about the partial settlement, as in the present case, after disclaiming and refusing to negotiate at all.⁶⁵

60. *Id.* (emphasis in original). Although *Zeig* is an old decision, it has been cited as good law in the Second Circuit as recently as 1992 in *Christiania Gen. Ins. Corp. v. Great Am. Ins. Co.*, 979 F.2d 268, 278 (2d Cir. 1992).

61. See Thomas Bower, *Partial Settlements By Primary Insurers - The Law*, 29 TORT & INS. L.J. 536, 539 (1994); see also *United States Fire Ins. Co. v. Lay*, 557 F.2d 421 (7th Cir. 1978) (court found insured's settlement of third party claim to be a sham because the primary carrier abandoned its duty to defend and stipulated to entry of an excess judgment against the insured).

62. 2 F.3d 98 (5th Cir. 1993).

63. In a first party case, where there would be no duty to defend, such collusion between the third party and the insured is far less likely. In any event, evidence of bad faith or collusion by the insured with either the primary insurer or third party claimants is best addressed as a defense to coverage under the excess policy rather than the basis for a manufactured claim of bad faith against the primary insurer.

64. See, e.g., *Gasquet v. Comm. Union Ins. Co.*, 391 So.2d 466 (La. Ct. App. 1980); and other cases cited at Bower, *supra* note 17

65. *Deblon v. Beaton*, 247 A.2d 172, 175 (N.J. Super. Ct. 1968).

Notwithstanding the foregoing, clear expressions of judicial acceptance of such settlements, excess carriers have argued that a Zeig settlement constitutes a breach of a duty of good faith owed by the primary insurer to the excess carrier. This argument was properly disposed of in *Allstate Insurance Co. v. Riverside Insurance Co. of America*,⁶⁶ The court held that such a settlement would not have violated any duty owed to the excess insurer, because the settlement was in the insured's interest, and satisfied the overriding duty to settle owed to the insured. The court also identified the inherent dilemma with which a primary insurer is faced in such situations, and then sided with the insured against the excess carrier as to the best way to resolve the dilemma:

At this point the primary carrier may be caught between two competing duties: first, to the excess carrier and second, to the insured. Assuming the primary carrier, after evaluating the [third party's claim], determines that it runs a substantial risk of having to pay the full \$100,000 [policy limits] were the case to go to trial and feels that a \$75,000 payment is justified because of that risk, it may then find, in the face of the [third party's] offer not to pursue the insured personally, that it has a duty to protect its insured by entering into the settlement thereby eliminating the insured's exposure to personal liability. Thus, the primary carrier may enter into the agreement.⁶⁷

Any argument that such a settlement constitutes bad faith enforceable by the excess insurer would also be defeated in any jurisdiction where the excess insurer's rights are limited to those it has as subrogee to the insured. As noted above, the excess insurer may only sue if the insured could have done so, but a release of the primary carrier as part of a Zeig settlement would likely extinguish any claims which the excess carrier would seek to assert against the primary carrier.⁶⁸

Given the foregoing, it would appear that in first party indemnity cases, the duty owed by the primary insurer to its insured to quickly settle claims may well preclude any claimed duty owed by the primary insurer to the excess insurer to insist on paying full policy limits.⁶⁹ When the insured and the primary insurer want to settle a claim, but the excess carrier's evaluation of the claim leads it to decide to contest coverage rather than participate

66. 509 F. Supp. 43 (E.D. Mich. 1981).

67. *Id.* at 47.

68. David Greenwald, *Partial Settlements by Primary Insurers - A Critique*, 29 TORT & INS. L.J. 555, 565 (1994)

69. The issue of whether the primary carrier can be said to have acted in bad faith towards the excess insurer in settlement negotiations is a separate issue from that of whether the excess insurer may be able to argue that a Zeig settlement is ineffective to trigger coverage under its policy. This article does not try to address the latter issue other than as set forth herein. The effectiveness of such a settlement in any given jurisdiction is an issue best left to counsel for the insured to resolve on a case by case basis.

in the settlement, a *Zeig* settlement allows the insured and the primary carrier to effect a partial settlement while at the same time, preserving the excess carrier's coverage dispute for later resolution.⁷⁰ Consequently, an insured and/or the primary insurer contemplating a *Zeig* settlement should, of course, invite participation by the excess insurer. Then, even if the excess insurer declines to participate, the settling parties will avoid any charge that they acted secretly, collusively, or without full disclosure to the excess insurer. Finally, in the event the excess carrier does not participate in the settlement, it should keep in mind the following:

[T]hat courts considering the validity of *Zeig* settlements will be influenced heavily by the universal judicial impulse to promote settlement, avoid trials, conserve judicial resources, and clear judicial calendars.⁷¹

IX. DUTY TO GIVE NOTICE

Another commonly debated "duty" claimed to be owed by a primary insurer to an excess insurer is that of having to give the excess insurer notice of a claim when it appears that it is likely the claim will be large enough to invoke the excess policy. However, in the fidelity context, although a primary insurer may want to voluntarily provide such notice, there is no real reason why it should be said to be legally obligated to give such notice.⁷² Once again, there is usually no contractual source for an alleged duty by a primary fidelity carrier to notify an excess carrier. Instead, the primary and excess policies usually place the duty to give notice of a claim squarely on the insured. Nevertheless, the existence of such a duty is often asserted, perhaps because of the clear duty of a primary liability carrier who undertakes to negotiate with the third party claimant to disclose to the insured, and to the excess insurer as subrogee, the amounts of any settlement offers in excess of the primary coverage. However, there should be no duty on the part of a primary indemnity carrier to advise the insured that the insured's own claim exceeds the amount of coverage available under the primary policy. Such information would be something the insured would be presumed to already know.

Another misguided source for the alleged duty to inform the excess insurer of the existence of a claim in excess of the primary insurer limits is

70. *Bower*, *supra* note 61, at 549.

71. *Id.* at 554.

72. Thomas A. Gordon and Donald J. Hirsch, *ESSENTIAL CONSIDERATIONS WHEN RESERVING RIGHTS OR DENYING COVERAGE, THE RIGHTS AND DUTIES OF PRIMARY AND EXCESS INSURANCE CARRIERS* (1993).

Principle 5 of the Guiding Principles discussed above.⁷³ Again, however, the Guiding Principles specifically apply to liability insurers and the handling of third party claims, not indemnity insurers resolving first party claims. Consistently, in *Monarch Cortland v. Columbia Casualty Co.*,⁷⁴ one of the few cases to discuss the issue of whether the Guiding Principles imposed a duty upon a primary carrier to give notice to the excess carrier, the court found such a duty to exist, but found it to spring from the insurer's contractual duty to defend:

The obligation to notify the excess carrier and insured of financial consequences for which there is no primary coverage is clearly a component party of "a careful defense."⁷⁵

Unless a primary fidelity insurer assumes the defense of third party claims against the insured, it would not appear that the Guiding Principles or any implied duty applicable to liability policies would create a duty to give notice of the first party claim to the excess carrier.

X. YES, BUT WHAT SHOULD WE DO?

As is exemplified by the very existence of the Guiding Principles, the insurance industry believes certain claims handling practices are necessary to better serve the insured and to avoid unnecessary controversy between primary and excess insurers. Clearly, there are reasons why some of the standards of conduct described in the Guiding Principles do not apply to first party fidelity claims. Other issues are not addressed by the Principles. However, each insurer must arrive at an internal understanding not only of what is required by law, but also what is expected within the industry as to the extent and degree of cooperation and communication between an excess and a primary carrier. This article has not attempted to provide an insider's view of what a primary insurer should do in handling a large claim.⁷⁶ It is only outside counsel's attempt to clarify the question of what is required by law. However, it is hoped that both excess and primary insurers can better serve their insureds and their industry the more realistic their understanding of their legal obligations to one another.

73. Principle 5 states: "If at any time, it should reasonably appear that the insured may be exposed beyond the primary limit, the primary insurer shall give prompt written notice to the excess insurer, when known, stating the results of investigation and negotiation, and giving any other information deemed relevant to a determination of the exposure...." *Monarch Cortland v. Columbia Casualty Co.*, 165 Misc.2d 98, 626 N.Y.S.2d 426,430 note (1995).

74. 165 Misc.2d 98, 626 N.Y.S.2d 426 (1995),

75. *Id.* at 431.

76. For such an analysis, see HAROLD J. FRIEDMAN, GUIDELINES FOR THE PRIMARY CARRIER IN DEALING WITH EXCESS CARRIERS, FOR THE DEFENSE, 22 (1995) and BALDWIN, *supra* note 5, at 40.

By contrast, equitable subrogation permits a paying insurer to “step into the shoes” of the insured and pursue recovery from third parties responsible to the insured for the loss for which the insurer has been held liable and paid.⁷⁷ Six essential elements have been identified as necessary to an insurer’s cause of action based on equitable subrogation:

- (1) the insured must suffer a loss for which the party to be charged is liable, either because the latter is a wrongdoer whose act or omission caused the loss or because he is legally responsible to the insured for the loss caused by the wrongdoer;
- (2) the insurer, in whole or in part has compensated the insured for the same loss for which the party to be charged is liable;
- (3) the insured has an existing, assignable cause of action against the party to be charged, which action the insured could have asserted for himself if he had not been compensated for his loss by the insurer;
- (4) the insurer has suffered damages caused by the act or omission upon which the liability of the party to be charged depends;
- (5) justice requires that the loss should be entirely shifted from the insurer to the party to be charged; and
- (6) the insurer’s damages are in a stated sum, usually the amount it has paid to its insured, assuming the payment was not voluntary and was reasonable.⁷⁸

77. *Fireman’s Fund Ins. Co. v. Maryland Casualty Co.*, 21 Cal.App.4th 1586, 26 Cal.Rptr.2d 762, 767-68 (1994).

78. *Id.* at 768.