The Insured's Right to Settle When the Insurer Is Defending under Reservation of Rights

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Scope

In an article in the Spring 2012 issue of Trial Trends entitled, When the Undefended Montana Insured Settles and Assigns Rights in Return For a Covenant Not To Execute, the author examined the insured’s right to settle a case when the insurer refuses a defense. Specifically, the article dealt with the increasingly common situation where the undefended insured is forced to settle by stipulating to judgment, and assigning his rights against his insurer to the claimant in return for the claimant’s covenant not to execute on the insured’s assets.

The natural segue for that article is examination of the insured’s right to settle when the insurer purports to fully defend, but does so under reservation of rights with the express intention of not indemnifying. This article will explore that topic and specifically address the extent to which the insured may settle the case and assign his rights against the insurer in return for a covenant when the insurer is defending but refusing indemnity.

As the prior article reflects, Montana has substantial case law developing the duty to defend and the rights and remedies of the insured when the insurer wrongfully refuses defense.2 In a Montana nutshell, if the insurer wrongfully refuses to defend, it has breached the policy contract and freed the insured to fend for himself regardless of the policy’s cooperation clause. The insured, who has no duty to defend himself in the first place, may settle by stipulating to judgment and assigning to the claimant any rights he has against the insurer in return for the claimant’s covenant not to execute on the insured’s property.

In Montana, the settlement is presumed reasonable and not collusive, but the insurer can challenge those presumptions.

The insurer which wrongly denies defense will be stopped from raising defenses it could have raised in the underlying action. Ultimately, in Montana, the insurer in the wrong will be liable for the underlying or “confessed” judgment, the insured’s attorney fees and costs expended in defending the underlying claims, interest on the judgment, and attorney fees in the coverage action that are recoverable under the Uniform Declaratory Judgment Act. All of this follows from wrongful failure to defend.

However, what if the insurer undertakes defense, but does so under reservation of rights? The “reservation of rights” letter is the insurer’s notice to the insured that it accepts tender of defense of the claim but believes there is no coverage for all or part of the claim, so that it does not ultimately intend to indemnify in the event a verdict against the insured results. Implicitly, this means the insurer intends no attempt at settlement either which is important, because the duty to settle is an integral part of the insurer’s obligation in Montana under Gibson v. Great Western Fire Ins. Co. (1984).3

Defending when the insurer believes there is no coverage seems illogical. The insurer does so because of the difference between obligations of defense and indemnity. Recall that liability policies such as auto, homeowners, and commercial general (CGL) all contain two distinct promises: first, that the insurer will indemnify the insured against loss by reason of legal liability to a third party, and, second, that the insurer will defend the insured in claims for such liability. The duty to defend is different from the duty to indemnify, independent from the duty to indemnify, and broader than the indemnification duty created in the same insurance contract.4 The duty to defend arises when a complaint against an insured alleges facts, which if proven, would result in coverage,5 or when the “insured sets forth facts which represent a risk covered by the terms of an insurance policy.”6 The insurer must defend on the allegations that fall within the policy no matter how groundless, false, or baseless the suit may be.7

The duty to indemnify is narrower. To obtain indemnity, it is the insured’s burden to prove on the facts that the claim falls into policy coverage.4 Consequently, the insurer may have to defend because of groundless allegations made in the complaint even though it believes the insured can never prove coverage. The Montana Supreme Court in Farmers Union Mut. Ins. Co. v. Staples (2004)8 warned that if the pleadings allege claims within coverage but the insurer believes it has a legitimate reason to refuse defense, it should tender defense under reservation of rights and file a declaratory action.

The Insured’s Situation Where the Insurer Defends Under Reservation of Rights.

If the insurer refuses to defend, the insured is free to settle the case.9 However, if the insurer denying coverage follows the advice of the court in Staples (2004), it will provide a defense to the insured along with a reservation of rights letter indicating that it does not plan on paying. The
Insurance will also file an action seeking a declaratory judgment that there is no coverage for the claim and that it should be relieved of duties under the policy. The insurer may even give the insured notice that, if it prevails in the declaratory action, it intends to seek reimbursement from the insured for any defense costs incurred in defending the allegations.11

While these procedures are good defense practice, they still place the insured in peril. Consider the situation in which Ribi Immunochem Research, Inc. in Western Montana found itself when it was defended under reservation of rights in a substantial environmental tort case by its CGL insurer, Travelers Casualty and Surety Company.12 The coverage issue was whether damage from contamination by Ribi’s disposal of hazardous wastes in the Bitterroot Valley Sanitary Landfill was “sudden and unexpected” so as to be an exception to the policy pollution exclusion, an issue on which courts around the nation have split. Travelers defended under reservation of rights and a notice to the insured that they intended to seek reimbursement of their defense costs. When the Montana Supreme Court ultimately ruled adversely to Ribi, the company not only suffered the loss it had tried to transfer to its insurer, but it also had to reimburse the insurer for the defense costs incurred in trial and appellate court proceedings.

As the author pointed out in the last article, the risk-averse insured paid a premium to the risk-neutral insurer on an agreement that risk of loss and risk of defense costs were transferred to the insurer. When the insurer tenders defense under reservation of rights, the insured is confronted with potentially ruinous economic risk, which he sought to transfer to the insurer in return for the premium paid. Couple that with the possibility of having to reimburse the insurer for any defense provided and one can see the tremendous pressure that will drive the insured to protect himself even if he is purportedly receiving a defense from the insurer. I say purportedly, because the carrier defending under reservation of rights is invariably not negotiating for settlement, which is an integral part of defense.

Is the Insurer Providing Defense if it Won’t Explore Settlement?

With regard to the insured rights to settle his own case, should the insurer that provides a defense under reservation of rights while seeking a declaratory judgment of no coverage be treated any different than the insurer that refuses defense in the first place? Does the insured have any less need to protect itself where the defense is being provided? The situation merits analysis.

On the positive side in such a case, the insurer provides defense expenses and an attorney who, under Montana’s In Re Rules of Professional Conduct13 case, owes sole duty of

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fidelity to the insured. To a certain extent, this addresses the conflict of interest inherent in accepting the insurer's defense during coverage disputes. On the negative side, the insurer is still in control of the litigation to the extent it controls negotiations, and the insurer will not tender any money offers until the coverage dispute is decided against it. The insured has little way of knowing whether the liability loss will ultimately fall on him. If the insurer is right, the insured may suffer a catastrophic loss of assets in satisfying a liability verdict and possibly reimbursing attorney fees. If the insurer is wrong, it may face the insured's claim in tort for failure to settle within limits and a claim for breach of contract for failure to indemnify.

What is the Insurer's Duty to Settle if it Denies Indemnity?

Since the landmark Jessen v. O'Daniel case in 1962, it has been established in Montana that an insurer is liable to its insured for failure to accept a reasonable settlement offer on a claim against the insured, and that the insurer must give the interests of its insured equal consideration with its own interests. Jessen said the defending insurer must consider the following factors in determining whether to settle for the benefit of its insured:

1) whether, by reason of the severity of the plaintiff’s injuries, any verdict is likely to be greatly in excess of the policy limits;
2) whether the facts in the case indicate that a defendant's verdict on the issue of liability is doubtful;
3) whether the company has given due regard to the recommendations of its trial counsel;
4) whether the insured has been informed of all settlement demands and offers;
5) whether the insured has demanded that the insurer settle within the policy limits;
6) whether the company has given due consideration to any offer of contribution made by the insured.15

The Montana Supreme Court recognized the duty to settle as part of the fiduciary duty of good faith and fair dealing inherent in every insurance policy in Gibson v. W. Fire Ins. Co., (1984):16

One of the usual benefits of a liability insurance policy is the settlement of claims without litigation, or at least without trial if the cause is litigated. The implied obligation of good faith and fair dealing requires the insurer to settle in an appropriate case, although the express terms of the policy do not impose the duty.

If the duty to settle is an inherent feature of the insurer's obligations to the insured, can any insurer purport to provide a full defense when it will entertain no offers of settlement, because it has raised a coverage issue? That question illustrates the fundamental conflict between the insured and the insurer defending him under reservation of rights.

The Insured's Right to Settle When the Insurer is Defending Under Reservation of Rights.

The Montana Supreme Court has never been called upon to rule specifically on a case in which the insured who is being defended under reservation of rights is forced to stipulate to judgment and assign rights against the insurer in return for a covenant not to execute. However, the court's decision in Peris v. Safeco Ins. Co. (1966)17 would appear to allow such a procedure. Ironically, Peris is a case in which the insured unilaterally settled while its insurer, Safeco, was not in breach of its promises to defend or to indemnify.

Peris involved an automobile injury claim in which Safeco fully defended its insured with no reservation of rights and engaged in negotiations for settlement. After having rejected earlier offers of limits, Safeco tendered the $100,000 policy limits, which were then refused by the third party claimant. The insured, who was worried about excess liability, then unilaterally settled the case for $35,894.85 over the limits. Safeco knew of the negotiations but neither consented nor objected. Safeco contributed its $100,000 limit and the insured contributed the balance. In essence, Peris is a case in which the insurer kept its promise to defend and indemnify, and the insured, unhappy with negotiations, stipulated to settlement without consent of the insurer. The insured then used that settlement to bring a cause of action under the unfair claims settlement practices act, MCA § 33-18-201 and 242, before the underlying claim was adjudicated.

In the bad faith suit, the jury awarded the insured Peris the excess he paid over the limits plus $250,000 punitive damages. On appeal, Safeco argued that the insured's conduct breached the policy's "No Action" clauses which read:

§ 5 . . . The insured shall not except at his own cost, voluntarily make any payment . . . other than for such immediate medical and surgical relief to others as shall be imperative at the time of accident.
§ 6 . . . No action shall lie against the company until after full compliance 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.

The Montana Supreme Court held that, under MCA § 33-18-242, "... it is not necessary that settlement be approved by the insurer or judgment be rendered before an insured may file a cause of action against his or her insurer alleging violation of the act." Moreover, the court held that "... an insured is entitled to maintain a cause of action under the Act prior to either an adjudication of the underlying claim of the third party against the insured or a written agreement by the insurance company settling the case, notwithstanding a 'No Action' clause in the insured's policy." The court rejected Safeco's assertion that the Peris type settlement encourages collusion between the insured and claimant, which makes the insurer liable.

Peris has two major imports for our inquiry: first, if the insured, Peris, could unilaterally settle the case and use the settlement as the basis for his bad faith action, then it follows that he could, in the alternative, have assigned to the claimant his right to do so in settlement of the excess for which he was legally obligated; second, if the insured whose insurer is defending and indemnifying has the rights the Montana Supreme Court allowed Peris, why would the insured being defended under reservation of rights have any less remedies? Peris should be all the authority one needs to allow an insured being defended under reservation of rights to settle by confessing judgment, assigning to the claimant rights against the insurer, and accepting a covenant not to execute in return.

Other courts have recognized that the insured being defended under reservation or rights has a right to protect himself by settling the case and that he can do so by stipulating to judgment and assigning his rights against his insurer in return for claimant's covenant not to execute on his assets. Minnesota, for instance, allows the insured being defended under reservation of rights to protect himself by settling and assigning. In Miller v. Shugart (1982), the insurer filed a declaratory action shortly after the subject auto accident to determine whether there was coverage for both the insured auto owner and the driver. Milbank Mutual hired separate counsel for the insured and the driver at its expense. The declaratory action was decided against Milbank which then appealed. Plaintiff then filed her lawsuit against the insured owner and driver. The parties to the personal injury action advised Milbank that they were negotiating settlement and Milbank refused while the coverage question was still pending. Upon learning that Milbank would not participate in settlement discussions, the defendant insured owner and defendant driver confessed judgment for $100,000, twice the policy limits, and received a covenant not to execute. Subsequently, the Minnesota Supreme Court affirmed that Milbank was wrong in its denial of coverage.

When plaintiff sought to recover the stipulated judgment from Milbank, the company argued that there had been no trial on the merits so that plaintiff's claim was still an unliquidated tort claim. The court refused that argument saying that, as between the plaintiff and defendants, the underlying tort claim was liquidated and reduced to judgment. The court also refused Milbank's position that a settlement which effectively obligates defendant insureds to pay nothing (by reason of the covenant) cannot be the basis for a claim against the insurer saying again that the confessed judgment "effectively liquidates defendant's personal liability." (The Wyoming Supreme Court in Gainso Ins. Co. v. Amoco Production Co. in 2002, also held as a matter of public policy that inclusion of the covenant not to sue in the settlement between the insured and claimant does not negate the fact of the judgment against the insured and does not bar the claimant from pressing the insured's assigned rights against the insurer.7)

The Miller court then considered whether the insureds had breached their contractual duty to cooperate by confessing judgment.20 The court looked to determine whether the insurer had breached its policy promises to defend and indemnify so as to release the insureds to settle. It concluded that Milbank "never abandoned its insured" nor "repudiated its policy obligations."21 Nevertheless, the court noted that neither did it accept responsibility for the insured's liability exposure," so that the

"I consider trial by jury as the only anchor ever yet imagined by man, by which a government can be held to the principles of its constitution."

Thomas Jefferson to Thomas Paine, 1789
question was the rights and duties of the parties while the coverage question is being resolved.22 The court found that the insureds' right to protect themselves while coverage was in doubt trumped any right of the insurer to have them wait to settle until the coverage question was resolved.23 The court said:

If, as here, the insureds are offered a settlement that effectively relieves them of any personal liability, at a time when their insurance coverage is in doubt, surely it cannot be said that it is not in their best interest to accept the offer. Nor, do we think, can the insurer who is disputing coverage compel the insureds to forego a settlement which is in their best interests.24

Consequently, the court held that the insureds did not breach their duty to cooperate with the insurer.

The court summarily disposed of Milbank's argument that the judgment was the product of fraud or collusion noting that no evidence of such fraud or collusion existed. More importantly, the court said that "[I]t seems to us, if a risk is to be borne, it is better to have the insurer who makes the decision to contest coverage bear the risk." The court noted that the risk of not participating in settlement negotiations is that of "... being required to pay, even within its policy limits, an inflated judgment."25

Finally, the court held that the plaintiff has the burden of proof of showing that the judgment was reasonable and prudent saying, "... the test as to whether the settlement is reasonable and prudent is what a reasonably prudent person in the position of the defendant would have settled for on the merits of plaintiff's claim."26

In the Washington case of Safeco Ins. Co. of America v. Butler (1992),27 Safeco defended a shooting case under reservation of rights on the ground that the shooting was not a covered "accident" under the policy. The insured settled with the badly-injured plaintiff on a stipulated judgment for $3,000,000, an assignment of the insured's rights against Safeco, and a covenant not to execute. The court found that such an agreement was not a release from liability but rather "... an agreement to seek recovery only from a specific asset -- the proceeds of the insurance policy and the rights owed by the insurer to the insured."28 The case does not appear to have involved a challenge to the insured's right to settle in the situation. We should note that the Washington Supreme Court in the prior case of Tank v. State Farm Fire & Cas. Co. (1986)29 and in Safeco Ins. Co. of America30 established that the insurer defending under reservation of rights has an "enhanced obligation" to protect the interests of its insured.

In the 1975 decision of Johansen v. California State Automobile Association Inter-Insurance Bureau,31 the California Supreme Court sitting en banc upheld a stipulated settlement and assignment where the insurer denied indemnity. In Johansen, the insurer rejected settlement offers because it was engaged in a declaratory action disputing coverage in which it prevailed. Prior to judgment in the declaratory action, the insureds suffered a tort verdict far in excess of the limits of their auto policy. Subsequently, an appellate court reversed the coverage decision that had been favorable to the insurer. The insureds then settled with the claimant by assigning their rights against the insurer in return for a covenant not to execute.

In essence, Johansen is a case in which the insured was legally liable for an excess verdict that the insurer says was not its responsibility. The insured unilaterally settled on an assignment and covenant, and the California Supreme Court upheld it saying, "California authorities establish that an insurer who fails to accept a reasonable settlement offer within policy limits because it believes the policy does not provide coverage assumes the risk that it will be held liable for all damages resulting from such refusal, including damages in excess of applicable policy limits."32

The court rejected the insurer's argument that liability does not attach so long as the insurer's denial was made in good faith, pointing out that the identical argument had been made and rejected in the seminal case of Comunale v. Trades & Gen. Ins. Co. in 1958.33 The court in Johansen saw no reason to depart from that settled law. The court quoted Comunale: "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 wrongful it is liable for the full

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amount which will compensate the insured for all the detriment caused by the insured’s breach of the express and implied obligations of the contract.”

Notably, Comunale involved a refusal to defend, which arguably distinguishes it from cases in which the insurer is defending but denying indemnity. However, the California court in Johansen said the insurer’s liability in Comunale did not turn on refusal to defend and quoted Comunale: “The decisive factor in fixing the extent of (the insurer’s) liability is not the refusal to defend; it is the refusal to accept an offer of settlement within the policy limits.”

In Taylor v. Safeco Ins. Co., in 1978, a Florida appellate court expressly found that Safeco had not breached its duty to defend driver, Earl Taylor, even while it was challenging coverage. Nevertheless, the court said, “Just as the insurer is not required to abandon its contest of a duty to pay as a condition of fulfilling an assumed or admitted duty to defend, the insured is not required to abandon control of his own defense as a price of preserving his claim, disputed by the insurer, that the insurer pay any judgment.” In Taylor, Safeco defended until it won a declaratory judgment that the defendant was not an insured under the policy, then Safeco withdrew before trial. When the insured subsequently appealed the declaratory judgment, Safeco again stepped in to defend at trial on the possibility that the defendant would be declared an insured.

However, Safeco was rebuffed by its insured, Earl Taylor, who refused the defense and elected to go to trial unrepresented where he settled the claim by confessing judgment. The appellate court held that Taylor did not breach the cooperation clause and was entitled to effect settlement of his case. The issue of whether there was coverage that would bind Safeco to pay the confessed judgment remained to be determined.

The court in Taylor said in dicta that, because Safeco did not breach any duty to defend, if coverage was ultimately declared, Safeco would only be liable for any reasonable settlement up to the limits of coverage. The holding is illogical and runs contrary to authority in Montana. In cases where the insurer has refused to defend, the Montana courts have held insurers responsible for stipulated settlements in excess of the limits. The question is whether failure to indemnify cases should be treated any differently. Where the rights assigned by the insured in settlement as a result of denial of indemnity include bad faith tort, the limits are irrelevant since we are talking about the insurer’s liability, which is not governed by limits of its insured’s policy and not the insured’s, which is.

The Arizona case of United Services Automobile Association v. Morris (1987) involved USAA’s claim that there was no coverage under their homeowner’s policy for an intentional shooting by their insureds. The company provided full defense under...
what the court determined to be a reservation of rights under a policy with a liability limit of $100,000 and an exclusion for injuries “expected or intended by the insured.” The insurance defense lawyer for the insureds notified USAA that the insureds were negotiating settlement with the plaintiff, and USAA objected but took no part in the negotiation. The insureds settled by confessing judgment for $100,000 in return for a covenant not to sue.

On appeal, the Arizona Supreme Court sitting en banc framed the issues of first impression which are squarely on point with our inquiry: “1. May two insureds being defended under a reservation of rights protect themselves by entering into a settlement agreement without breaching the cooperation clause? 2. If so, is the settlement binding on the insurance carrier?” The Arizona Supreme Court followed Minnesota’s Miller v. Shugart in finding that, while the insurer “did not ‘abandon’ its insured by breaching any policy obligation, neither did it accept full responsibility for its liability exposure.”

The court characterized USAA’s position as “...the cooperation clause gave it a right to force the insureds to reject any settlement, no matter how reasonable, risk trial, and place themselves at danger of a judgment larger than the policy limits or one that might not be covered.” To allow that, the court reasoned, would be to allow the insurer two bites at the apple: It could defend the case to avoid liability, and, if that failed, file the declaratory action to avoid coverage, and escape liability by winning either. During both bites, the insured would risk financial catastrophe. Accepting USAA’s position would completely free the insurer from that part of the duty to defend, which consists of the duty to settle.

The court rejected USAA’s position but acknowledged that the insured’s settlement is often motivated by “strongly felt need for economic survival” and the plaintiff’s desire for a quick judgment. “The better result would permit the insurer to raise the coverage defense and also permit an insured to protect himself from the risk of non-coverage or excess judgment, while at the same time protecting the insurer from unreasonable agreements between the claimant and the insured.” Consequently, the court held that the insured being defended under a reservation of rights has the right to settle by confessing judgment and receiving a covenant not to sue and can do so without breaching the cooperation clause.

The court then held that the insurer is not bound by the settlement unless the insured or claimant showed that the settlement was reasonable and prudent. It specifically rejected USAA’s argument that USAA had “an absolute right to litigate all aspects of the liability case including liability and amount of damages,” a position that the court said would destroy the purpose of allowing the insured to settle in the first place. The court affirmed that the insured doesn’t have to prove that he would have lost the case but only “that given the circumstances affecting liability, defense and coverage, the settlement was reasonable.”

Citing Miller v. Shugart, the court said, “The test as to whether the settlement was reasonable and prudent is what a reasonably prudent person in the insured’s position would have settled for on the merits of the claimant’s case.”

We should note here that Montana has, since Independent Milk & Cream (1923) presumed, according to MCA § 28-11-316 (formerly § 8169 rev. Codes 1921), that the insured’s settlement in the face of breach by the insurer is reasonable. The presumption is rebuttable, but the burden is on the insurer under Independent

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Milk & Cream.\(^5\) While Independent Milk & Cream was a failure to defend case, there is no reason the rule should be different for failure to indemnify. The insured needs the same protections, and the insurer is the party that makes the expert decision to take the risk of denying coverage forcing the insured to protect himself.

As was pointed out when the author treated settlement in the face of refusal to defend, the insured who is being denied indemnity must negotiate to avoid financial catastrophe, has meager negotiating power, and must do whatever it takes to free himself from the loss that will cause financial ruin. The insurer that will indemnify is risk neutral and has the loss built in to its actuarial calculations, premiums, and reserves. It would be unfair to judge the settlement procured by the insured by what the insurer, a party in a powerful negotiation position, would do. Hence, the presumption of reasonableness is logical, and the only real question is whether the settlement has been procured by fraud or collusion.

The Limit to the Insured’s Right to Settle When Refused Indemnity

If the insurer is providing defense with no reservation of rights, it is not in breach of the policy, and the insured is not released from any duty to cooperate. Settlement in such a case is still in the discretion of the insurer, and independent action by the insured to settle the case, even when the insurer refuses a reasonable in-limits offer would likely breach the cooperation clause. In the Arizona case of State Farm Mut. Auto. Ins. Co. v. Peaton (1990),\(^5\) State Farm’s insured, Peaton, faced liability for negligently colliding with an adolescent on his bicycle causing him brain damage and quadriplegia. State Farm defended with no reservation of rights and tendered the $50,000 policy limits in an attempt to settle the case. When settlement negotiations hung up on the issue of interest in addition to the limits, the insured settled with the claimant on a “Damron” agreement,\(^9\) which is essentially confession of judgment and assignment to the claimant of the insured’s bad faith claims against its insurer in settlement of the third party claims against the insured, in return for a covenant not to execute on assets of the insured. The Arizona Supreme Court held that the insured breached the cooperation clause by so doing, because the insurer had not breached any part of its contract. The court, citing Vindt,\(^4\) noted that the insurer makes two explicit promises, defense and indemnity, and one implied promise, to treat settlement proposals with equal consideration of the insured’s interests.\(^5\) In Peaton, the court found no breach by the insurer that would justify settlement by its insured. However, the court contrasted Peaton with United Services Automobile Association v. Morris\(^6\) where it asserted the insured was freed from the obligation of the cooperation clause because the insurer was defending under reservation of rights. Said the court of Morris, “Thus, the insurer’s reservation of rights amounted to the insurer not accepting full responsibility for its insured’s liability exposure and allowed the insureds to sign a Damron agreement without being in violation of the cooperation clause.”\(^5\)

In Peaton, State Farm argued that only breaches of express duty to defend or indemnify could release the insured from obligations under the cooperation clause allowing the insured to settle. The Arizona court rejected that argument finding instead that “...the better reasoned cases impose upon the insurer the obligation to initiate and attempt settlement and the failure to do so may constitute ‘bad faith’ which would subject the insurer to liability in excess of policy limits.”

California’s 2002 case of Hamilton v. Maryland Casualty Co.\(^8\) is in accord with Peaton. There, the insured dating service was sued for violation of clients’ privacy in a complaint that proposed certification for a class action. It appears that the insurer defended, did not deny indemnity, and offered $150,000 in settlement in response to an offer to settle within policy limits, which it refused. At that point, the insured stipulated to a judgment in excess of policy limits and assigned its rights against the insurer in return for a covenant not to execute. The California court held that, where the insurer was defending (and negotiating), the stipulated judgment without trial was insufficient to show that the insured had suffered damage to any extent by the insurer’s failure to settle.

Nevertheless, the Montana Supreme Court in Paris v. Safeco Ins. Co. (1966)\(^9\) honored a unilateral settlement by the insured while Safeco was intent on defending, indemnifying and negotiating pursuant to its policy promises. As was reported, the court found the stipulated settlement did not violate the “No Action” clause and could be the basis for the bad faith claim.

Does the Insurer Then Have to Settle Even if There is No Coverage?

In California’s Johansen case, the insurer argued that holding the insurer liable regardless of its good faith in refusing indemnity means that insurers must settle in all cases even when there is no coverage. The court noted that, if the insurer’s position of no coverage had been vindicated, there would be no liability for damages for its refusal to settle. Said the court, “...all that Commare establishes is that the insurer who fails to settle does so ‘at its own risk.”\(^10\) The court noted that the insurer “...retains the ability to enter an agreement with the insured.
reserving its right to assert a defense of non-coverage even if it accepts a settlement offer. If having reserved such rights and having accepted a reasonable offer, the insurer subsequently establishes the non-coverage of its policy, it would be free to seek reimbursement of the settlement payment from its insured.65

The insurer’s lament about being assessed liability for having failed to settle a case in which coverage was disputed may invoke some sympathy. However, aside from the fact that such liability comes only if the decision to deny indemnity was wrong, it is worth considering the import of the alternative. The defending insurer either has a duty to settle or it does not. If the courts were to hold that the insurer defending under reservation of rights has no duty to settle even if it is later adjudged that it wrongfully denied coverage, then that insurer has a huge advantage over the insurer which defends without reservation of rights. The insurer defending without reservation of rights must abide by the law of Jessen v. O’Daniels to avoid exposure to excess liability. The insurer that defended while denying indemnity would be entirely free of exposure to excess liability creating an incentive to defend whenever possible under reservation of rights.

Can the Insurer use the “Reasonable Basis” Defense of MCA § 33-18-242?

The statutory “reasonable basis” defense of MCA § 33-18-242 does not apply to free the insurer from settlements stipulated as a result of the insurer’s wrongful refusal to defend or indemnify. The Unfair Claims Settlement Practices statute, MCA § 33-18-201, specifies fourteen things insurers may not do in claims settlement. Subsection (6) is “neglect to attempt in good faith to effectuate prompt, fair, and equitable settlement of claims in which liability has become reasonably clear.” MCA § 33-18-242 is the result of the Montana Legislature’s 1987 attempt to corral the remedies available to consumers against insurance companies. Subsection (3) of that statute limits the remedies of the “insured” against the insurer:

(3) An insured who has suffered damages as a result of the handling of an insurance claim may bring an action against the insurer for breach of the insurance contract, for fraud, or pursuant to this section, but not under any other theory or cause of action. An insured may not bring an action for bad faith in connection with the handling of an insurance claim.

Hence, the insured is limited to three remedies, 1) breach of contract, 2) fraud, or 3) an action “pursuant to this section.” Breach of contract and fraud are not actions “pursuant to this section.” This is important, because, for actions “pursuant to this section,” the legislature has given the insurers a specific defense as set forth in subsection (5):

“(5) An insurer may not be held liable under this section if the insurer had a reasonable basis in law or in fact for contesting the claim or the amount of the claim, whichever is in issue.” This defense is available only if the action is brought “under this section,” and is not available if the action is for breach of contract or fraud.

Logically, the action being brought for failure to indemnify is the insured’s assigned claim for breach of contract and not a claim “under this section,” because “this section” refers to MCA § 33-18-242.
which provides for “independent action” based on subsections (1), (4), (5), (6), (9) or (13) of MCA § 33-18-201. An insurer may comply with each of those specified provisions, and still wrongly refuse indemnity. For example, the insurer may perform a prompt and reasonable investigation and timely report to the insured that it will defend under reservation of rights and cite to the policy language that it believes is the basis for denying coverage. If it is later adjudged wrong in its denial of coverage, it is liable for breach of the insurance policy contract. The action for breach will not be subject to a defense of “reasonable basis in law or fact” in such an action.

While MCA § 33-18-242 says that the “insured may not bring an action for bad faith in connection with the handling of an insurance claim,” this language has been interpreted by the Montana Supreme Court not to apply to coverage disputes between the insurer and the insured. Thomas v. Northwestern Nat’l Ins. Co.62 (1998). In Thomas, the court said that the Legislature did not intend the UTPA to be the exclusive remedy for insureds bringing litigation against their insurers pointing out that MCA 33-18-242(6)(a) provides “an insured may file an action under this section, together with any other cause of action the insured has against the insurer.”63

As a matter of public policy, Montana courts should make clear that the insurer proven to have wrongfully denied indemnity is not freed from any duty to settle within limits while it did so. Moreover, the courts should assure that the insurer which defends while denying the duty to indemnify is not better off than the insurer which defends while agreeing to indemnify and attempting to settle the claim.

Conclusion
The insured being defended under a reservation of rights because the insurer disputes coverage is for all practical purposes not any better off than the insured being denied defense. In each case, the insured faces ruinous liability claims which he sought to protect against by transferring the potential losses to the insurer in return for a premium. In that grave uncertainty, the insured often needs the protection of settling by stipulating to a judgment, assigning to the claimant rights against the insurer in satisfaction of the judgment, and receiving a covenant not to execute in return.

That remedy which is available to the insured denied defense should also be available to the insured denied indemnity. Risk of fraud or collusion is no different for either situation, and the insurer is free to present evidence of such. Montana’s presumption that

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such a settlement is reasonable can be rebutted by the insurer.

The insurer is only responsible for the stipulated settlement if it is found to have wrongly denied indemnity by defending under reservation of rights. When the insurer wrongly denies liability, it breaches its contractual promise to indemnify and frees its insured from the “Cooperation” and “No Action” provisions of the policy leaving the insured free to protect himself as he can. The insurer that disputes coverage rightly should take the risk that the risk-averse insured will be forced to settle through stipulation, assignment, and covenant. That risk is identical to the risk that the insurer by law takes when it denies the insured a defense. The risk is also similar to that which the insurer takes when it refuses an offer within limits. In each of those situations, the insurer has the expertise, underwriting experience, and assets to deal with the risk that it will be ultimately liable for if its decision was wrong. The insured bears the entire loss if the insurer is correct in denying coverage and may be financially ruined. The challenge for the courts in Montana is to make sure that the insured who is wrongly denied indemnity is not deprived of the only port in the storm, the chance to settle with the only power the insured has, the power to assign his rights against the wrongdoing insurer in return for a covenant not to execute on the insured assets.

ENDNOTES
1. The author thanks 3L student Keif Storrar for research, citation and editing assistance; MTLA member Gary Zadick for review and comment; and MTLA members Pat Sheehy and Dan Buckley for editing.
2. For legal authority for any statements in this recap of the last article, see Munro, When the Undefended Montana Insured Settles and Assigns Rights in Return For A Covenant Not to Execute, Trial Trends, 21-36, Sept. 2012.
9. 90 P.3d 381 (Mont. 2004).
10. Indep. Milk & Cream Co. v. Aetna Life Ins. Co., 216 P.1109 (Mont. 1923); Staples, 90 P.3d at 384, 386.
12. Id.
15. Id. at 326-327.
17. 916 P.2d 780.
18. 316 N.W.2d 729.
19. 53 P.3d 1051.
20. Miller, 316 N.W.2d at 733.
21. Id.
22. Id.
23. Id.
24. Id. at 333-334.
25. Id. at 334.
26. Id.
27. 823 P.2d 499.
29. 105 Wash. 2d 381, 715 P.2d 1133.
30. Safeco Ins. Co., 823 P.2d at 03.
31. 538 P.2d 744 (Cal. 1975)
32. Id. at 744.
33. 328 P.2d 198 (Cal. 1958).
34. Id., 328 P.2d at 202.
35. Id., 328 P.2d at 201.
36. 361 So.2d 743 (Fla. 1st Dist. App. 1978).
37. Id., 361 So. 2d at 745.
38. Id., 361 So. 2d at 746.
39. Id.
40. Id., 361 So. 2d at 747.
42. 741 P.2d 246, 248 (Ariz. 1987).
43. Id. at 250.
44. Id. at 251.
45. Id.
46. Id. at 252.
47. Id.
48. Id.
49. Id. at 253.
50. Id.
51. 216 P. at 1111.
54. A. Windt, INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSURED) § 4.01 to 6.37, at 100-297 ([1982]).
55. Peaton, 812 P.2d at 1010.
57. Peaton, 812 P.2d at 1010.
58. 41 P.3d 128 (Cal. 2002).
59. 276 Mont. 486, 916 P.2d 780.
60. Johansen, 538 P.2d 744.
61. Id. at 750.
62. 973 P.2d 804.
63. Id., 973 P.2d at 809. *