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Three Is A Crowd: Revisiting The Third Party Beneficiary Doctrine

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Commentary

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This article examines the third party beneficiary doctrine in conjunction with the approaches courts follow with regard to the collection of an excess judgment from a liability insurer.

I. Collecting an Excess Judgment

A. Overview

All or most courts find that the common law duty of good faith and fair dealing is owed to an insured, not to a third party claimant.[1] These duties are based upon the existence of a contractual relationship between the insurer and the insured. However, an insured's cause of action against his or her liability insurer for failure to settle within the policy limits is often brought by the third party claimant.[2] Several jurisdictions have enacted statutes allowing a third party claimant to pursue an action against a liability carrier after obtaining a judgment against the insured.[3] A few jurisdictions give the third party claimant the right to bring a direct action solely against the insurer, or jointly against the insured and the insurer.[4] Few jurisdictions permit third parties to bring a common law "bad faith" action directly against the insurer without an assignment from the insured.[5]

B. Obtaining an Assignment from the Insured: Minority & Majority Views

The majority of jurisdictions require a third party claimant to obtain an assignment of the insured's right of action against the insurer before proceeding to recover an excess judgment from the insurer on a common law "bad faith" theory. In New Jersey, for example, an injured third party cannot pursue a direct claim against the insurer to recover the excess verdict beyond the policy limits absent an assignment from the insured.[6] In support of its holding, the court in *Murray v. Allstate Insurance Company*, examined the basis for which an insured may recover against the insurer for its failure to exercise good faith in settling a claim within the limits of the policy.[7] Such right of an insured "is predicated upon the potential damage to the *assured* in being subjected to a judgment in excess of her policy limits and the consequent subjection of her assets to the satisfaction of such judgment."[8] The court went on to further state that the injured third party is a "stranger in that sense" and that public policy "does not mandate that the injured party in the accident should be deemed the intended beneficiary of the company's contractual duty to its policyholder to act in good faith regarding settlement."[9] New Jersey's bankruptcy statute coincides with this principle.[10] Section 17:28-2 limits the injured party's action against the carrier for the amount of the judgment "not exceeding the amount of the policy."[11]

Also, under West Virginia law, common law bad faith claims do not extend to third parties to allow third parties to bring an action against the insurance carrier of another. In fact, under West Virginia law, the injured third party is not considered a third party beneficiary of

the insurance contract between the insurance carrier and its insured.[12] In *Elmore v. State Farm Mutual Automobile Insurance Company*, the court stated that "the common law duty of good faith and fair dealing in insurance cases under our law runs between insurers and insureds and is based on the existence of a contractual relationship."[13] "In the absence of such a relationship there is simply nothing to support a common law duty of good faith and fair dealing on the part of insurance carriers toward third party claimants."[14]

Finding that there is no fiduciary relationship between a third party claimant and a tortfeasor's liability insurer, the court in *Elmore* examined the settlement process of a claim. In the settlement process, the relationship between an insurer and a third party claimant is adversarial and because of that adversarial relationship, "the law cannot expect the insurer to subordinate its interests to those of the third party."[15] Also, "the insurer already has an implied duty of good faith and fair dealing to its insured."[16] "[I]n deciding whether or not to settle the insurer must be as quick to compromise and dispose of the claim as if it itself were liable for any excess verdict."[17] "The significant duty owed by the insurer to the insured certainly forecloses any like duty owed by the insurer to the third party who is the adversary of the insured."[18] "An insurer cannot logically owe a duty of good faith and fair dealing to the insured and a fiduciary duty to an adversarial third party in the same matter."[19] However, the third party is not without a legal remedy. The third party claimant may pursue a bad faith settlement claim by filing an administrative complaint pursuant to W. Va. Code § 33-11-4a.

Florida represents the minority view with regard to the ability of third party claimants to bring a bad faith claim directly against the liability insurer in the absence of an assignment from the insured. Construing a third party claimant as an intended third party beneficiary to the insurance contract, Florida permits an injured third party to maintain an action against the insurer to recover in excess of the insured's policy limits without an assignment from the insured. In *Thompson v. Commercial Union Insurance Company*, the Supreme Court of Florida held that "a judgment creditor may maintain suit directly against tortfeasor's liability insurer for recovery of the judgment in excess of the policy limits, based upon the alleged fraud or bad faith of the insurer in the conduct or handling of the suit."[20] In *Thompson*, a judgment was obtained against the insured for an amount in excess of the policy limits. The claimant brought suit against the insured's carrier for the balance of the judgment, alleging that the carrier was in bad faith for failing to settle the claim originally within the limits of the policy.[21] There was no assignment from the insured to the claimant of possible claims against the insurer.[22] Looking to the line of authority invalidating the anti-direct action clause in the standard automobile policy,[23] the Court found that a third party judgment creditor can sue the tortfeasor's liability insurer directly, without an assignment, to recover a judgment in excess of the policy limits.[24]

C. Insured's Prepayment of an Excess Judgment (Prepayment Rule)

Under the earlier prepayment rule, an insured was required to pay the excess judgment before suit was brought against the insurer.[25] The rationale behind requiring an insured to pay the excess judgment stems from the perspective that the insured is not harmed until he or she pays out-of-pocket.[26] The "existence of an outstanding judgment, which may never be paid, is not a legal injury, for the injury in such case is pecuniary loss."[27] However, a concern behind the prepayment rule is that it would "serve as a windfall to an insurer fortunate enough to have insured an insolvent."[28] The prepayment rule is contrary to the rule followed by the majority jurisdictions.

D. Final Judgment Entered Against the Insured (Judgment Rule)

Now, the modern rule or the majority approach does not require an insured's prepayment of the excess judgment prior to bringing an action against the insurer for failure to settle within the policy limits.[29] The tort is complete when a final judgment is rendered. The assertion that an insured is not damaged because he or she cannot pay the excess judgment "is based upon the fallacy that damaged credit and financial ruin are not injuries."[30] Regardless of the insured's assets, an excess judgment "will potentially impair [an insured's] credit, force [an insured] into bankruptcy, diminish [an insured's] reputation, subject [an insured's] outright property to lien, and immediately subject any future earnings to possible garnishment."[31]

However, there are rare circumstances where the court found that insurers were not liable to an injured party for failure to settle within the policy limits. For example, an action was not maintainable against the insurer

when the insured was insolvent before the excess judgment and the insured was discharged in bankruptcy.[32] Another example where the court denied a judgment creditor recovery against an insurer was when an insured was deceased and his insolvent estate had no interest in whether the judgment exceeded the policy limits.[33] In *Bourget v. Government Employees Insurance Company*, the court examined the basis for imposing the duty on liability insurers to exercise good faith or due care with respect to settling within policy limits.[34] "[T]he conflict between the insurer's interest to pay less than the policy limits and the insured's interest not to suffer liability for any judgment exceeding them" is what gives rise to such duty of liability insurers.[35] The court acknowledged that there are rare instances where an insured has no such interest.[36] As such, there can be no conflict between the insured and the insurer and no duty arises.[37]

II. Inconsistencies with the Third Party Beneficiary Doctrine

As a result of the duty of good faith and fair dealing, an insurer is required "to give the insured's interests consideration at least equal to that of its own."[38] An excess judgment against an insured "constitutes the damage that permits the insured to recover for breach of the duty owed."[39] Since that duty arises out of a contractual relationship, the insured has the right to pursue his or her insurer for damages that result from the insurer's failure to settle within the policy limits.[40] Accordingly, the duties are owed to the insured rather than the third party claimant, who is a stranger to the insurance contract.

In addition, the parties to the contract must actually and expressly intend to benefit the third party to give a nonparty to a contract the status of a third party beneficiary.[41] Absent an assignment, applying the intended third party beneficiary doctrine in the bad faith context is inconsistent with the duties of good faith and fair dealing that an insurer owes to its insured. The benefit that the contracting parties intended to confer to a third party is the insurance contract's limits of insurance, not an unknown sum in excess of the policy's limits.

This is also consistent with the line of cases recognizing the personal relationship between the insured and the insurer when analyzing contribution between insurers of a mutual insured.[42] Courts have recognized that the duty to defend involves a personal relationship between the insured and the insurer.[43] In Florida, for instance, when one of two co-primary insurers wrongfully refuses to defend a mutual insured, only the insured can sue the non-defending insurer for breach of the duty to defend.[44] Courts prohibit one co-primary insurer from suing the other for failing to discharge this obligation that is personal to the insured.

III. Conclusion

Just as courts have receded from the prepayment rule, courts should recede from the legal fiction that allows a third party claimant to assert a common law "bad faith" claim against the insurer without an assignment from the insured. Permitting the claimant to seek the amount of the excess judgment in her own right, as if entry of an excess judgment caused damage to her, is intellectually dishonest. Deeming the claimant to be a "third party beneficiary" of the insurance contract does not support a conclusion that her independent right to sue the insurer extends to sums in excess of those contemplated by the contract.

To the extent that this rule results in inequities, legislative solutions are available. For example, legislatures can prevent the development of an assignment marketplace by prohibiting an insured from receiving any consideration from the claimant beyond discharge of the judgment, and requiring the insurer to make extracontractual payments on an excess judgment directly to the claimant. Legislatures can also enact statutes designed to curb unfair claims handling practices. Those statutes can create a cause of action in favor of a third party claimant even without an assignment. Such statutes will prevent an insurer from obtaining an undeserved "windfall" if the insured is not in a position to assign its rights to the claimant, as in the case of a deceased insured with no estate. Those same statutes can prevent claimants from manufacturing bad faith claims by requiring a claimant to give the insurer a chance to "cure" its alleged bad faith by paying the policy limits in exchange for a release of the insured.

Endnotes

1. O.K. Lumber Co., Inc. v. Providence Washington, Ins. Co., 759 P.2d 523 (Alaska 1988); Scroggins v. Allstate Ins. Co., 393 N.E.2d 718, 721 (Ill. App. Ct. 1979); Herrig v. Herrig, 844 P.2d 487 (Wyo. 1992); Dvorak v. American Family Mut. Ins. Co., 508

N.W.2d 329 (N.D. 1993); Elmore v. State Farm Mut. Auto. Ins. Co., 504 S.E.2d 893 (W. Va. 1998).

2. Restatement (Second) of Contracts § 302 (1979) (adopting the "intent to benefit test" and recognizing two types of third party beneficiaries: intended beneficiaries and incidental beneficiaries).

3. Conn. Gen. Stat. Ann. § 38a-321; Iowa Code Ann. § 516.1; Fla. Stat. Ann. § 627.4136; Ala. Code § 27-23-2; Md. Code Ann., Ins. § 19-102.

4. La. Rev. Stat. Ann. § 22:1269; R.I. Gen. Laws Ann. §§ 27-7-1, 27-7-2 (authorizing direct actions against the insurer when the injured party, after good faith efforts, is unable to serve process upon the insured).

5. Thompson v. Commercial Union Insurance Company, 250 So. 2d 259, 264 (Fla. 1971).

6. Murray v. Allstate Ins. Co., 507 A.2d 247 (N.J. Super. 1986).

7. *Id.* at 250.

8. *Id.* (emphasis in original).

9. *Id.*

10. *Id.* (citing N.J.S.A. § 17:28-2).

11. *Id.*

12. Elmore v. State Farm Mut. Auto. Ins. Co., 202 W. Va. 430, 438 (W. Va. 1998) (a contract must be made for the third party's sole benefit in order for a contract to give rise to a third party's independent cause of action and the insurance contract was not made for the sole benefit of the third party).

13. *Id.*

14. *Id.*

15. *Id.* at 436.

16. *Id.*

17. *Id.* (quoting Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990)).

18. *Id.*

19. *Id.*

20. 250 So. 2d 259, 264 (Fla. 1971).

21. *Id.* at 260.

22. *Id.*

23. *Id.* at 260-263 (discussing Shingleton v. Bussey, 223 So. 2d 713 (Fla. 1969) and Beta Eta House Corp., Inc. of Tallahassee v. Gregory, 237 So. 2d 163 (Fla. 1970)).

24. *Id.* at 264.

25. Dumas v. Hartford Accident & Indemnity Company, 26 A.2d 361, 362 (N.H. 1942), *overruled in part*, Dumas v. State Farm Mut. Auto. Ins. Co., 274 A.2d 781 (N.H. 1971).

26. *Id.*

27. *Id.*

28. Dumas v. State Farm Mut. Auto. Ins. Co., 274 A.2d 781, 782 (N.H. 1971).

29. *Id.*; Frankenmuth Mut. Ins. Co. v. Keeley, 447 N.W.2d 691, 697 (Mich. 1989) (adopting the judgment rule and holding that "when an insurer has exhibited bad faith in failing to settle a claim on behalf of its insured and a judgment in excess of the policy limits results, the insurer must pay the excess judgment in its entirety without regard to whether the insured has the capacity to pay").

30. *Dumas*, 274 A.2d at 782.

31. *Keeley*, 447 N.W.2d at 697.

32. Harris v. Standard Acc. & Ins. Co., 297 F.2d 627 (2d Cir. 1961).

33. Bourget v. Government Emp. Ins. Co., 456 F.2d 282 (2d Cir. 1972).

34. *Id.* at 285.

35. *Id.*

36. *Id.*; *see also* Levantino v. Ins. Co. of North America, 422 N.Y.S.2d 995 (finding that the New York rule is threefold: "1) where the assured pays part of the judgment or is solvent enough to do so at the time of the excess judgment, the judgment rule applies and he is entitled to the full amount of the excess as his damages; 2) where he was insolvent before the judgment and obtained a bankruptcy discharge after it, he is not damaged and may not recover for it; and 3) where he was insolvent or nearly insolvent prior to the judgment the jury must consider his past, his prospects, and other economic factors and assess his damages").

37. *Id.*

38. Scroggins v. Allstate Ins. Co., 393 N.E.2d 718, 720 (Ill. App. Ct. 1979).

39. *Id.*

40. *Id.*

41. *See* Security Mut. Cas. Co. v. Pacura, 402 So. 2d 1266 (Fla. 3d DCA 1981).

42. Argonaut Insurance Company v. Maryland Casualty Company, 372 So. 2d 960, 964 (Fla. 3d DCA 1979); Pennsylvania Lumbermens Mut. Ins. Co. v. Indiana Lumbermens Mut. Ins. *Co.*, 43 So. 3d 182, 186-88 (Fla. 4th DCA 2010).

43. *Argonaut*, 372 So. 2d at 964; *Pennsylvania Lumbermens*, 43 So. 3d at 186-88.

44. *Argonaut*, 372 So. 2d at 964; *Pennsylvania Lumbermens*, 43 So. 3d at 186-88. ■

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