Enforceability of Consent to Settle Clause in Excess Insurance

by

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I. Introduction

Excess insurance policies commonly contain clauses which: (a) prohibit the insured from voluntarily making a payment or incurring an obligation without the insurer's consent; or (b) state that no action shall be taken against the insurer for a recovery unless the insurer has agreed to such recovery or it has been determined by trial and final judgment (hereinafter collectively called "Consent to Settle"). The purpose of such clauses is to allow the insurer to maintain control of the dispute resolution process and prevent the insured from committing the insurer to payment of claims that the insurer wishes to contest. The purpose of this article is to explore selected case law that enforces such clauses as well as case law with subordinates such policy language to certain public policy interests.

II. Consent to Settle Clause Enforced

Perhaps the most extreme example of this group of cases is a decision in a dispute certified to the Georgia Supreme Court by the Eleventh Circuit: *Piedmont Office Realty Trust v. XL Specialty Ins. Co.,* 297 Ga. 38 (2015). The insured was a defendant in a federal securities class action suit and it had already exceeded its primary layer of insurance when it sought the approval of the excess insurer for $6 million from the excess layer to achieve a settlement. The excess insurer offered $1 million and without the excess insurer's permission, the insured settled the claim for $4.9 million from the excess layer. The settlement was approved by the court in which the underlying claim was pending but the excess insurer declined to contribute to the settlement.

The insured sued the excess insurer for breach of contract and bad faith but the Georgia Supreme Court found for the excess insurer:

> [T]he plain language of the insurance policy does not allow the insured to settle a claim without the insurer's written consent. It also provides that the insurer shall only be liable for a loss that the insured is "legally obligated to pay." Finally, the policy contains a "no action" clause which stipulates that the insurer may not be sued unless, as a condition precedent, the insured complies with all of the terms of the policy and the amount of the insured's obligation to pay is determined by a judgment against the insured after a trial or a written agreement between the claimant, the insured, and the insurer. In light of these unambiguous policy provisions, we hold that [the insured] is precluded from pursuing this actions against [the excess insurer] because [the excess insurer] did not consent to the settlement and [the insured] failed to fulfill the contractually agreed upon condition precedent.[1]

The Georgia Court went on to find it irrelevant that the excess insurer had denied coverage and that the insured's settlement was approved by the court in which that claim was pending. Based on the Georgia Supreme Court's reading of Georgia law, the Eleventh Circuit found for the excess insurer in *Piedmont Office Realty Trust v. XL Specialty Ins. Co.,* 790 1252 (11th Cir. 2015).

Actions by the SEC and other regulatory agencies against Bear Sterns provided the fact situation for *Vigilant Ins. Co. v. Bear Stearns Cos., Inc.*, 10 N.Y. 3d 170 (2008). Bear Stearns settled the monetary claims and three days after executing the settlement agreement sought the approval of the excess insurers. A federal district court found the settlement to fair, adequate and in the public interest. The Court of Appeals found that Bears Stearns violated the Consent to Settle provision of the excess policies:

> As a sophisticated business entity, Bear Stearns expressly agreed that the insurers would not be liable for any settlement in excess of $5 million entered into without

> their consent. Aware of this contingency in the policies, Bear Stearns nevertheless elected to finalize all outstanding settlement issues and executed a consent agreement before informing its carriers of the terms of the settlement. Bear Stearns therefore may not recover the settlement proceeds from the insurers.[2]

Stryker Corp. v. National Union Fire Ins. Co. of Pittsburgh Pa., 842 F.3d 422 (6th Cir. 2015) involved claims for pre-mature failure of artificial knees. The insured had an umbrella policy and an excess over that. Both companies baulked at the insured's request for defense and indemnification with the umbrella insurer denying coverage and the excess waiting to determine if losses would penetrate its layer. During more than ten years of litigation between the insured and the umbrella insurer, the insured unilaterally settled all the claims against it and after the fact, sought insurance proceeds from the excess insurer. The excess insurer resisted based on a Consent to Settle clause. The court rejected the insured's effort to obtain retroactive consent and ruled for the excess insurer:

> The plain language of the policy mandates "compromise with the written consent of the [the excess insurer]." Not "separate and apart from," not "retroactively," and certainly not over a decade "after the fact." [The insured's] retroactivity argument, we thus conclude, improperly employs the obligation of good faith and fair dealing to "override express contract terms." What is more, [the insured's] reading of the contract runs up against the obvious purpose of the consent-to-settle provisions – to *prospectively "give* the insurer the opportunity to contest liability, to participate in settlement negotiations and to have input as to the value of the claim."[3]

See also Federal Ins. Co. v. Arthur Anderson LLP, 522 F.3d 740 (7th Cir. 2008) in which it is not clear whether the insurance involved is primary or excess. The insured, Arthur Anderson, was sued over pension benefits by former partners. Arthur Anderson appointed defense counsel and controlled the defense to the exclusion of its insurer, occasionally providing information to the insurer about the progress of the dispute. Eventually, Arthur Anderson proposed a settlement and asked the insurer to contribute its policy limits but the insurer declined as the claim was not covered by the insurance. Arthur Anderson completed the settlement and sought recovery from the insurer. The court found no coverage but also ruled that there was a violation of the Consent to Settle clause:

> A clause in the policy commits Arthur Anderson not to settle any claim for more than $250,000 without Federal Insurance's "written consent, which shall not be unreasonably withheld." . . . Arthur Anderson didn't ask for the consent or even the comments of his insurers; it presented the deal to them as a *fait accompli.* By cutting Federal Insurance out of the process, Arthur Anderson gave up any claim to indemnity . . . .[4]

III. Consent to Settle Clause Not Enforced

An influential case on point is *Diamond Heights Homeowners Assn. v. National American Ins. Co.,* 227 Cal. App. 3d 563 (1991). This case involved a suit by a homeowners association against a developer. The umbrella insurer was advised of the suit and that underlying insurance limits would likely be exhausted. The umbrella insurer monitored the suit but did not defend it. When a settlement demand was made, the umbrella insurer offered a small amount in contribution that was inadequate to settle the dispute. Eventually, the insured and underlying carriers settled without the approval of the umbrella insurer. The settlement was approved by the trial court over the objections of the umbrella insurer.

The California intermediate appellate court stated the issues as follows:

> Were the primary insurers entitled to settle the case for an amount that invaded excess coverage without the excess insurer's consent? Conversely, did the excess insurer have the absolute right under [the Consent to Settle clause] to object to and therefore preclude any settlement which invaded excess coverage, even if reasonable and made in good faith, thereby compelling the primary insurer to continue the litigation and provide a defense through trial? We find these questions are of first impression under California law.[5]

The court observed that an excess insurer has a good faith obligation, when considering a settlement negotiated by an underlying insurer, to consider whether the settlement has a reasonable relationship to potential liability and maximum likely recovery as well as the costs involved if the matter continues to trial. "Consistent with its good faith duty, the excess insurer does not have the absolute right to veto arbitrarily a reasonable settlement and force the primary insurer to proceed to trial, bearing the full costs of defense."[6] This is necessary to promote fair and reasonable settlement of lawsuits.

The *Diamond Heights* court went on to rule that this good faith obligation affects a waiver of Consent to Settle clauses:

> Although such a holding is in apparent conflict with the [Consent to Settlement clause], we conclude that the excess insurer *may* waive its rights under that clause if it rejects a reasonable settlement at the same time as it fails to offer to undertake the defense.[7]

The court observed that the umbrella insurer's protection against an excessive settlement was objection at the good faith settlement confirmation hearing that occurred in this case.

Diamond Heights was followed as the articulation of California law on point in *Teleflex Med. Inc. v. National Union Fire Ins. Co.*, 2017 U.S. App. LEXIS 4996 (9th Cir.). This case involved trade disparagement and false advertising counterclaims. The insured and primary insurer negotiated a settlement that invaded the excess layer but which was contingent on the approval of the excess insurer. After extended negotiations, the excess insurer failed to approve the settlement or to take over the defense of the claim. Eventually, the insured finalized the settlement after which the excess insurer agreed to take over the defense if the insured could "undo" the settlement. Instead, the insured sued the excess insurer for breach of contract and bad faith and received a favorable jury verdict.

The *Teleflex* court articulated the *Diamond Heights* rule as giving an excess insurer three options when presented with a settlement offer approved by the insured and primary insurer: (1) approve the proposed settlement; (2) reject it and take over the defense; and (3) reject the settlement, decline the defense and face a possible lawsuit by the insured.[8] The Court of Appeals stated:

> *Diamond Heights* is about how an insurance policy should be read in order to reconcile an excess insurer's contractual rights under [Consent to Settle clauses] with the insured's rights under the implied covenant of good faith and fair dealing. In other words, notwithstanding the court's use of the term "waiver" in *Diamond Heights*, the rule is not so much about the waiver of an insured's contractual right than it is about an insurer's breach of contractual obligation.[9]

The court ruled that under the facts of this case, the jury could rationally conclude that the settlement proposed was reasonable and the excess insurer exercised bad faith in rejecting it and failing to take over the defense.

Investors sued the insured for violation of securities law in *Schwartz v. Liberty Mutual Ins. Co.,* 539 F.3d 135 (2nd Cir. 2008). The principal of the insured reached a tentative settlement with the investors the night before he was to testify and gave the insurers that night and the morning before the trial resumed to consider the settlement. The insurers were unable to react in time and the insured settled with the insurers thereafter rejecting the settlement. The insured sued the excess insurers for breach of contract and bad faith. Notwithstanding the Consent to Settle clause, the jury found that the insurers had adequate time to consider the settlement offer, that he settlement offer was reasonable and that the insurers unreasonably withheld consent to settle. The court found that there was sufficient evidence to support this verdict and ruled for the insured.

IV. Commentary

As the above case law indicates, there is tremendous variation from jurisdiction to jurisdiction as to how this issue is treated by the courts. Some courts, such as the *Piedmont Office* court will enforce Consent to Settle clauses regardless of the reasonableness of the settlement offer. Other courts, such as the *Diamond Heights* court, would affect a waiver of or otherwise negate Consent to Settle clauses if the settlement is found to be reasonable by a jury or the court.

While it does not seem possible at this time to reconcile these disparate decisions, it is not difficult to perceive the reasons for them. Courts sometimes struggle with contracts that give excess insurers unfettered discretion to reject settlement offers. The problem for excess insurers is the tendency of courts, juries and insureds to regard any settlement within excess limits as reasonable.

ENDNOTES

[1] 297 Ga. 38 at 41-2.
[2] 10 N.Y. 3d at 178.
[3] 842 F.3d at 429 – 430 (internal citations omitted).
[4] 522 F.3d 740 at 744.
[5] 227 Cal. App. 3d at 580.
[6] *Id.*
[7] *Id. at* 581.
[8] 2017 U.S. App. LEXIS 4996 *1.
[9] *Id. at* *20.