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Insurance Settlement Dilemma: The Policyholder's Right to Settle When Insured and Insurer Disagree

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1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Noise And The Decision To Settle Within Insurance Policy Limits

May 16, 2019 | Policyholder Protection, Insurance

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In a blog post earlier this year, I discussed the problem of "noise" – or randomness – in professional judgments, in particular judgments regarding the value of claims and lawsuits. A recent case from the United States Court of Appeals for the Seventh Circuit illustrates the danger and cost of this noise with regard to insurance policy limits and the decision whether to settle. It provides a valuable lesson for policyholders facing lawsuits and liabilities that may exceed their insurance policy limits.

The case involved a lawsuit filed against a surgery center by a woman who was rendered quadriplegic as a result of a complication that occurred during a surgery performed at the center. The woman alleged the surgery center had been negligent in discharging her.

The Policy Limits and Liability Evaluation

The surgery center had insurance coverage with a duty to defend, but with liability limits of only $1 million. The insurance company hired defense counsel for the surgery center, but advised the center that it may want to retain personal counsel to advise it regarding the potential exposure above

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the $1 million policy limits. It appears the surgery center did not retain personal counsel, but the center's president (who was an attorney) was involved in the communications with defense counsel regarding settlement.

The insurance company, defense counsel, and the surgery center's president all believed that the case was defensible. They believed that, while the woman's damages certainly exceeded $1 million, the center had not been negligent and, therefore, it was not liable for her injuries. The insurance company set an initial reserve of $560,000, but then increased that reserve to $1 million after a summary judgment for the center was reversed on appeal. The insurance companies' representatives claimed the increase in reserve reflected only the potential damages, and not any assessment of the surgery center's potential liability.

The Policy Limits Settlement Rejection and the Jury's Excess Verdict

The attorneys for the injured woman offered to settle the case for the center's policy limits of $1 million. The insurance company rejected the offer with the agreement, and even urging, of the surgery center's president. The case went to trial and a jury found against the surgery center and awarded $5.17 million to the injured woman. The case then settled for $2.25 million, with the surgery center's insurance company paying its $1 million policy limits and the surgery center paying the remaining $1.25 million.

The Policyholder's Lawsuit Against the Insurance Company for Failure to Settle Within Policy Limits

After the settlement, the surgery center sued its insurance company for bad faith failure to settle the case within its $1 million policy limits before trial. Under the Illinois law applicable to the case, an insurance company has a duty to accept a settlement within its policy limits where there is a "reasonable probability" of a recovery in excess of policy limits and a "reasonable probability" of a finding of liability against its insured.

During the trial of the surgery center's bad faith claim, the judge entered judgment in favor of the insurance company finding that it did not have a duty to settle. The Seventh Circuit agreed and affirmed the judgment. The Seventh Circuit noted that Illinois law was unclear on exactly what the "reasonable probability" standard required, but it held that judgment was correct as a matter of law because the surgery center had presented no evidence that there was a reasonable probability that it would be found liable under any definition of this standard.

The Seventh Circuit based its ruling on the following rationale:

Juries can be unpredictable, so there is always a possibility of liability in a jury trial even in the strongest cases. That mere possibility of liability is not enough to prevent an award of judgment as a matter of law for [the insurance company]. Surgery Center needs *evidence* that its liability was reasonably probable for the duty to settle to have arisen – it has none.

The Seventh Circuit essentially concluded that because everyone involved with the defense of the underlying case believed that the surgery center would not be liable, its insurance company did not have any duty to settle – even though everyone also agreed that the jury's award would exceed the policy limits if liability was found.

The Lesson

This result provides a caution for any policyholder facing the potential for an adverse verdict in excess of its policy limits. As the surgery center discovered, the pride of believing in your case can lead to the prejudice of having to pay the cost of a verdict in excess of your policy limits.

Many states will allow recovery above policy limits where the insurance company failed to settle within policy limits, with the various states imposing different standards of conduct on the insurer. Policyholders facing claims and lawsuits that may exceed their policy limits should police these standards and may need to push for the required analysis, or they may face being left in the same position as the surgery center in this recent case. An insurance company that believes the limits of its liability will be capped at its policy limits may not care much about the probability of an outcome in excess of its limits, particularly where its policyholder agrees with its evaluation of the case.

We know from Daniel Kahneman's research on "noise," discussed in my earlier blog post, that the belief by the insurance company, defense counsel, and the surgery center's president that the center would not be found liable is not necessarily reliable. Kahneman likely would not view their belief as evidence for or against a reasonable probability of a liability finding. The Seventh Circuit seemed to acknowledge as much, by its comment that juries are unpredictable and any result is possible.

Yet, in the absence of other evidence showing that an adverse result in excess of policy limits was reasonably probable, both courts involved in this case concluded that this collective belief essentially doomed the surgery center's case. This begs the question of what evidence would have been sufficient for the courts to have concluded that the surgery center was at least entitled to have a jury consider its failure-to-settle claim.

While Kahneman might suggest there are no "experts" in evaluating cases like the one brought against the surgery center, courts frequently allow expert testimony on the question of whether an insurance company wrongfully failed to settle within policy limits. A policyholder may therefore present expert testimony on whether an excess verdict was reasonably probable.

Methods used by qualified jury research professionals also may be used to present evidence of the reasonably probable outcomes of a lawsuit like the one brought against the surgery center. The results of jury research performed in the underlying case may provide that evidence; or, if no jury research was performed, such research may be conducted during the failure-to-settle case to show that the insurance company wrongfully failed to settle the previous case against its policyholder within policy limits. In some cases, the fact that the insurance company failed to perform jury research to evaluate the probable outcome of a case brought against its policyholder may be evidence that the insurance company wrongfully failed to settle within policy limits.

Even without expert testimony or jury research, a policyholder may be able to present a jury question on whether its insurance company failed to settle within policy limits. In the case of the surgery center, while the opinion of any one person may be "noise," the fact that at least someone viewed an adverse result in excess of policy limits as reasonably probable may have been sufficient for the courts in the case to have at least allowed the question to be decided by the jury. Courts also have allowed evidence of alleged errors in handling a case that the policyholder contended prevented a settlement

within policy limits to support a failure-to-settle claim.

In a “noisy” environment, believing in your own press, as they say, can be costly. Policyholders faced with the possibility of an adverse judgment in excess of their insurance policy limits should push for case evaluations that fairly represent the likelihood of an excess judgment. The failure to do so may leave them exposed to an uninsured loss and without evidence necessary to prove their insurance company failed to protect their interests by settling within policy limits.

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The Noisy Business Of The Law And Insurance Claims

January 2, 2019 | Policyholder Protection, Insurance, Claims

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A Nobel Prize-winning psychologist and a legal scholar are working on a book about noise, but the noise they are focused on is not about sound; it is about randomness in decision making.

The Nobel Prize winner, psychologist Daniel Kahneman, was turned on to this noise while working as a consultant for an insurance company on the valuation of large financial fraud claims. What he discovered is something those of us in this area have told clients for years – the value of your claim depends, at least in the first instance, on the individuals tasked with evaluating it.

On Noise and Decision Making

Kahneman and his colleagues gave the same facts to 50 insurance underwriters at the same company and asked them to place a value on the potential claim. The insurance company's management expected that their underwriters' valuations would differ by 10 percent or so. What Kahneman found was that the underwriters' valuations differed by 50 percent. It was closer to 60 percent when the experiment was replicated at another

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insurance company. These results caused Kahneman to conclude, as he indicated in a recent interview with economist Tyler Cowen, that the companies were essentially "wasting their time."

In a Harvard Business Review article reporting on the results of this work, Kahneman and his colleagues wrote, "Replacing human decisions with an algorithm should be considered whenever professional judgments are noisy." In his interview with Cowen, Kahneman went so far as to conclude that the idea we humans are needed for most decisions is an "illusion." It seems even professional judgment is not immune to destruction at the hand of technology. We thought robots would destroy civilization in the future, but it seems only algorithms are necessary—a fate predicted by the 1983 movie "War Games."

Fortunately for us humans (aka non-algorithms), Kahneman and his colleagues spared us by also concluding that replacing humans with algorithms "in most cases … will be too radical or simply impractical." As a (presumably non-optimal) alternative, they proposed adopting procedures that promote consistency by ensuring that employees in the same role use similar methods to seek information, integrate it into a view of the case, and translate that view into a decision.

Presumably Kahneman's upcoming book with legal scholar Cass Sunstein (author of "Nudge") will have more advice on eliminating noise in professional judgments. Unfortunately, the book isn't due out until late 2020 or early 2021. Let's hope that the algorithms haven't taken over by then.

Noise in the Legal System

Lawyers have, at least intuitively (more on intuition in a moment), felt Kahneman's noise since the founding of our legal system. Having a single judge or a single arbitrator rule on a particular case is a harrowing experience for most lawyers and litigants. Our legal system is largely based on a jury system, which operates similarly to Kahneman's interim solution for bridging the gap between algorithms and humans.

Jurors receive the same facts and instructions and independently translate those into a decision, which they then discuss in an effort to arrive at a unanimous verdict. This is why jurors generally are not allowed to discuss the case with each other while it is ongoing, or to collect outside information. Appeals operate in a similar way, with each branch of the appeal generally adding justices to the decision-making process—usually three justices at the intermediate appellate stage, five justices at the state supreme court level, and nine justices if the case reaches the U.S. Supreme Court.

The legal concept of stare decisis – or following prior precedent – also should help reduce noise. If an issue has been decided on roughly equivalent facts in a prior case in the controlling jurisdiction, the parties and their lawyers should be safe in assuming it will be followed again under the same or substantially similar set of facts.

But stare decisis works only where the facts are the same or substantially similar, and a lot of noise can seep in when comparing past and current fact patterns. Indeed, the underwriters in Kahneman's insurance consulting work were experienced underwriters who presumably knew the precedent that would be applied to the cases they were asked to evaluate, but they came to substantially different valuations regardless.

Nevertheless, as Kahneman himself has advised in his other research,

looking at how a similar thing turned out in other instances is useful in trying to predict how it will turn out in the present instance.

Intuition Best Backed by Research

Experienced lawyers and insurance claims adjusters will answer all of this by pointing to their unique experience and proclaiming that their intuition of the value of cases is correct. But, it turns out humans are poor judges of their own opinions and tend toward overconfidence.

Truly useful intuition develops only under certain conditions, identified by Kahneman and Gary Klein as (1) a high-validity environment with distinct rules (think chess); (2) a high level of experience in that environment (think Grand Master); and (3) rapid and unequivocal feedback (think winning or losing the chess match).

This is where jury research comes in to help save us from ourselves. As a trial lawyer, nothing is more humbling than watching and listening to a group of mock jurors discuss your case and your arguments from behind a two-way mirror. When performed correctly, jury research (or, as we often prefer to call it, “theme development”) should at least muffle the noise present in any legal case or insurance claim.

One of the primary goals of jury research is to identify the types of noise (or themes) that are likely to enter a case. It then seeks to see how those noises interact with each other. Of course, a lot of individual and group psychology creeps into this process that is beyond the scope of this post.

Analyzing the data and arriving at predictions from jury research also takes certain skills not necessarily possessed by trial lawyers. Phil Tetlock, in his research on forecasting, has noted that the best forecasters (what he calls “superforecasters”) are “cautious, humble, open-minded, analytical – and good with numbers.” He also recommends a team-driven approach governed by specific rules. Trial lawyers are trained in the law and the art of persuasion, not the elements of good forecasting. Good jury researchers provide these skills and help both in the evaluation of cases and the development of the themes most likely to resonate with the greatest number of people likely to hear the case.

It will be interesting to see the analysis and solutions offered by Kahneman and Sunstein and their impact on how we evaluate insurance claims and other disputes. In the meantime, parties and their attorneys should focus on the identification and reduction of noise through consistent procedures and proper forecasting techniques for successfully resolving insurance claims and other disputes. (That is, until the algorithms come for us.)