

**FEDERATION OF REGULATORY COUNSEL, INC.**

**PROTECTION OF THIRD PARTY CLAIMANTS UNDER THE NAIC  
MODEL UNFAIR CLAIMS SETTLEMENT ACT**

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The Delaware Department of Insurance recently brought unfair claims settlement practices charges<sup>1</sup> against a liability carrier under Delaware's version of the NAIC Unfair Claims Settlement Practices Model Act.<sup>2</sup> The matter was ultimately dismissed on grounds that the Department failed to establish that the liability carrier in question had engaged in a general business practice. However, what makes the matter of special interest is that it is the first enforcement in recent memory in which the Delaware Department attempted to bring unfair claims settlement charges against a carrier for claims settlement activities related to a *third party claimant*. Counsel for the carrier<sup>3</sup> argued, *inter alia*, that the matter should be dismissed because the Unfair Claims Settlement Practices Act should not be made applicable to third party claims but, because the matter was dismissed on other grounds and because Delaware courts have not squarely addressed the question, the issue remains alive in Delaware.

At first blush, one might view the victims of an insured's malfeasance as the persons who are in the greatest need for the protections afforded by the statute. After all, these persons, who are not in privity of contract with the liability carrier, cannot rely on traditional contract remedies in the event a liability carrier fails to pay a claim to the satisfaction of the claimant. Thus, it would seem, extending the Unfair Claims Settlement Practices Act to third parties is in concert with the insurance regulator's duty to protect the public. In fact, however, extension of the Unfair Claims Settlement Practices Act to third party claimants would run headlong into established law in most jurisdictions holding that the duty of a liability carrier runs only to its insured and not to third party claimants.

Parties to an insurance contract are expected to deal with others in good faith, and the right to control settlement gives rise to a corresponding duty of good faith and fair dealing with the insured.<sup>4</sup> The heart of every bad faith action is the fiduciary relationship between the insurer and the insured and the duty of good faith and fair dealing implicit in every contract.<sup>5</sup> That this duty runs only to an insurance company's insured is derived from the covenant implicit in the insurance contract establishing the insurer as the representative of the insured.<sup>6</sup> By contrast, the third party claimant has no contract with the insurer or the insured, has not paid any premiums and has no legal relationship to the insurer or special relationship of trust with the insurer.<sup>7</sup> It follows that the tort of bad faith is not available to third party claimants who are strangers to the insurance contract.<sup>8</sup>

It has oft been noted that giving third parties the right to bring insurance bad faith claims in connection with settlement actions of a tortfeasor's insurer gives rise to a serious conflict for the insurer, who not only must protect the interests of its insured, but also must safeguard its own interests from the adverse claims of the third party claimant. This conflict disrupts the settlement process and may disadvantage the insured.<sup>9</sup> The existence of this conflict has not gone unnoticed in Delaware. In *Hostetter v. Hartford Ins. Co., Inc.*,<sup>10</sup> the Delaware Superior Court considered a commercial general liability policy issued by The Hartford to an installer of woodstoves. Following a fire caused by one of the insured's installed stoves, the injured plaintiff demanded that The Hartford settle plaintiff's claim. Initially, The Hartford denied coverage but later reconsidered that decision and settled a portion of the claim and went to arbitration on the remainder. Following arbitration, the plaintiff/claimant brought suit alleging bad faith, fraud and associated claims. In granting summary judgment in favor of The Hartford, the court held:

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The insurer has a fiduciary duty to the insured, but an adversary relationship with the victim. The effect of the policy is to align the insurer's interests with those of the insured.

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The special duties imposed on issuers with regard to their insureds are derived from the special fiduciary relationship between insurer and insured. No special justification exists for imposing greater duties on an insurer in dealing with an injured third party than in any other interaction between adversaries.<sup>11</sup>

The well-reasoned arguments in favor of precluding a third party claimant from bringing suit against a tortfeasor's liability insurer operate with equal force when applying the Unfair Claims Settlement Practices Act to the insurer's handling of third party claims. In particular, is the acute conflict of interest imposed upon every liability carrier each time it is faced with a third party claim. If the insurer acts to protect the interests of its insured, as it must under its duty to defend,<sup>12</sup> it will inevitably cause some delay in the settlement of the claim, and because counsel retained by the insurer for the insured must represent the interests of the insured and not the insurer, the claim may well not settle at all. If, as recognized by the Delaware Superior Court, the insurer is in an adversarial relationship to the third party claimant with respect to the insured's relative liability for the claim and the damages that follow, it cannot simultaneously have a duty to the same third party to settle and pay the claim.

A number of courts have recognized this inherent conflict and, building on the lack of any duty under common law theories, have held that the Unfair Claims Settlement Practices Act does not extend to third party claimants.<sup>13</sup> The Connecticut Superior Court in *Richards v. Deaton*,<sup>14</sup> addressed the issue of whether a cause of action for an unfair claims settlement practice under Connecticut's Unfair Claims Settlement Practices Act can originate from a complaint by a third party who is not insured under the defendant insurer's policy. The *Richards* Court rejected any notion that an unfair settlement practice could exist under such circumstances and specifically noted that to allow such a claim would "interfere with the insurance company's right and duty to defend its insured."<sup>15</sup> Furthermore, the Court noted that to allow a third party to "short circuit" the insurer's obligation and duty to defend "would undercut the constitutional right to contest a claim and have a trial."<sup>16</sup> The Texas Supreme Court came to a similar conclusion in *Allstate Ins. Co. v. Watson*:

Recognizing concomitant and coextensive duties under art. 21.21 to third party claimants, parties adverse to the insured, necessarily compromises the duties the insurer owes to its insured. In fact, the logical result of permitting a separate and direct cause of action in favor of third party claimants allows third parties to sue for unfair claim settlement practices *even though the insured has no claim for an unfair claim settlement practice*. As troublesome, it is conceivable that in attempting to settle claims pursuant to the demands of a third party claimant, insurers may be liable to the insured for settling too quickly. [citing cases] In refusing to provide a direct cause of action for third party claimants, the legislature may well have been aware of this potential for conflicting duties. We will not construe art. 21.21 or *Vail*, absent explicit directive from the legislature, so as to compromise the insurer's loyalties and obligations owed to the insured.<sup>17</sup>

Adopting similar reasoning, a number of other courts have also held that the Unfair Claims Settlement Practices Act does not extend to third party claimants.<sup>18</sup> Naturally, there is an exception to every rule, and in this case, a number of jurisdictions have expressly allowed a third party claimant to enforce the Unfair Claims

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Settlement Practices Act against a liability carrier; however, in each of these jurisdictions a special statutory provision was relied upon by the courts in order to extend the Act to third party claimants.<sup>19</sup> At least two courts have denied a third party the right to a private cause of action, but nonetheless imply, *in dicta*, that the Commissioner might have enforcement authority. <sup>20</sup> The author finds no court, however, that has squarely addressed the issue of whether a Commissioner may enforce the Unfair Claims Settlement Practices Act in a state that prohibits it to third parties; and we think that if and when the issue does come directly before these courts, such offhand *dicta* will be given careful scrutiny given that enforcement by the Insurance Commissioner has precisely the same deleterious effects as enforcement by private citizens.<sup>21</sup>

Given the weight of authority generally against the application of the Unfair Claims Settlement Practices Act to third party claims (absent special statutory provisions), courts in states such as Delaware that have yet to consider the issue should tread carefully when presented with the opportunity to do so. When the time comes, these courts should hold that the Act should not apply to a third party, either in the case of a private lawsuit or in the case of an appeal from an administrative enforcement action. To do otherwise is to open the door to an untenable conflict of interest, forced settlements in cases when the insured's liability is questionable, an infringement of the insured's right to a jury trial, and a general increase in litigation burdening our already overtaxed courts.

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### Endnotes

1. *In Re Joseph Renzi*, Docket No. 811-2008, DE DOI No. 37890
2. 18 *Del. C.* § 2304(16)
3. The author hereof
4. 14 Couch on Ins.
5. *Kranzush v. Badger State Mut. Cas. Co.*, 307 N.W.2d 256, 261 (Wis. 1981).
6. *Id.* (citing *Murray v. Mossman*, 355 P.2d 985 (Wash. 1960)); *Duncan v. Lumbermans Mut. Cas. Co.*, 23 A.2d 325 (N.H. 1941).
7. *Allstate Ins. Co., v. Watson*, 876 S.W.2d 145, 149 (Tex. 1993).
8. *Messina v. Nationwide Mut. Ins. Co.*, 998 F.2d 2, 5 (U.S. Ct. App. D.C. 1993)(citations omitted); see also *Simmons v. Pau*, 94 P.3d 667 (Haw 2004).
9. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 758 P.2d 58,67 (Cal. 1988); *Krupnik v. Hartford Acc. and Ind. Co.*, 34 Cal.Rptr.2d 39; *Chapell v. Larosa*, 2001 WL 58057 at \* 7 (Conn. Super., Jan. 5, 2001).
10. 1992 WL 179423 at \*7-8 (Del. Super. Jul. 13, 1992).
11. *Id.* Delaware courts have permitted third party suits in special circumstances in which the plaintiff was an intended third party beneficiary. See *Pierce v. International Ins. Co. of Ill.*, 671 A.2d 1361 (Del. 1996) (giving employees rights to bring bad faith claims against employer's workers compensation carrier as intended third party beneficiaries); *Swain v. State Farm Mut. Auto. Ins. Co.*, 2003 WL 2285345 (May 29, 2003) (relying on *Pierce*, holding injured automobile passenger was intended third party beneficiary of driver's uninsured motorist coverage).

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12. For duty to defend generally, see 16 *Williston on Contracts* § 49:103 (4th ed.); 1 *Insurance Claims and Disputes* 5th § 4:1.
13. Generally, these are courts in jurisdictions that allow private causes of action under the Unfair Claims Settlement Practices Act.
14. 1993 WL 78613 at \*2 (Conn. Super. March 11, 1993).
15. *Id.*
16. *Id.*
17. *Allstate Ins. Co. v. Watson*, 876 S.W.2d at 150.
18. See *Moradi-Shalal*, *supra*; *Wilson v. Wilson*, 468 S.E.2d 495 (N.C. App.1996); *Scroggins v. Allstate Ins. Co.*, 393 N.E.2d 718 (Ill. App. 1979); *Herrig v. Herring*, 844 P.2d 487 (Wyo. 1992).
19. See, e.g., *Auto-Owners Ins. Co.*, 658 So.2d 928 (Fla. 1995)(applying Fl. Stat. Ann. § 624.155); *Jenkins v. J.C. Penney Cas. Ins. Co.*, 280 S.E.2d 252 (W.Va.1981)(overruled on other grounds *State ex rel. State Farm Fire & Cas. Co. v. Madden*, 451 S.E.2d 721 (W.Va. 1994))(applying W.Va. Code § 55-7-9); *Shilhanek v. D-2 Trucking*, 70 P.3d 721 (Mont. 2003)(applying Mont. Code Ann. § 33-18-242); *Farris v. United States Fidelity and Guaranty Co.*, 587 P.2d 1015 (Or. 1978)(applying Or. Rev. Stat. § 746.230(b)); *State Farm Mut. Auto. Ins. Co., v. Reeder*, 763 S.W.2d 116 (Ky. 1988)(applying Ky. Rev. Stat. Ann. § 446.070).
20. *Kranzush*, *supra* at 268; *Dassault ex rel. Walker-Van Buren v. American Intl. Group, Inc.*, 99 P.3d 1256, 1259 (Wash. App. 2004).
21. The NAIC revised the Unfair Claims Settlement Practices Act in 1990 to revise it and remove it from the Unfair Trade Practices Model Act. These changes and revisions did not include any general extension of protection to third parties. See NAIC Unfair Claims Settlement Practices Act, WestLaw 900-1; NAIC Unfair Claims Settlement Practices Act Legislative history, Westlaw 900-9; and NAIC Unfair Property/Casualty Claims Settlement Practices Model Regulation, Westlaw 902-1.