

The Hammer Clause is your friend

In professional malpractice cases, utilize the conflict the insurer causes its insured to resolve your case

By Greg Stannard

The latch on the door to the mediation room clicks softly as it closes behind the mediator. Sitting down at the conference room table, and arranging her notes in front of her, the mediator grimaces as she glances down the table at you.

"Well," she says, "that didn't work so well. They're not going to make any offers on your case."

All that work.

Getting ready for the mediation, meticulously preparing the brief, gathering all of the most critical documents, taking the time to explain how there was no way you were going to lose.

Your client's expectations ran high, supported by your comments about how good the professional-negligence case was looking, about how the defense had *no answer* for the best parts of your case. And now, there is no offer? At all??

"It's the defendant. He's refusing to consent to any settlement offers by the carrier."

"So, even though they say they want to make an offer," says the mediator, an eyebrow rising as she makes this last comment, "they can't, because the policy requires the defendant to consent to any settlement."

How could it be, that the least knowledgeable person in the room – the defendant – who is fully protected by insurance, who has none of his own money in play, and who literally knows nothing about litigating and trying cases, holds such a grip on your case?

There is far, far more here than meets the eye.

Start with this fact, which many plaintiff lawyers don't know:

It is actually the insured defendant who often is the pawn used by the carrier. The insurance company wants to pressure the plaintiff lawyer into reducing a demand so that a case settles for much less than its actual value.

The carrier silently observes while the insured acts belligerent and indignant because of your lawsuit. The insured adamantly opposes any offers, even while that insured itself is completely unaware of the horrific consequences of this kind of conduct.

This happened in a real-life case, in which the insurer was attempting to exploit the consent clause to justify a zero offer.

How does this happen, and what tools can plaintiff lawyers use to force carriers – who are relying on the consent clause – to settle cases in the face of such a provision?

The Hammer Clause

Insurance policies that are issued to professionals such as lawyers, doctors and architects can contain "consent" clauses, which permit insured defendants to prevent their insurers from entering into settlements without their permission.

Ostensibly these consent clauses are placed in the policies to give the professional a voice in the settlement process, because of reporting requirements or other circumstances in which evidence of claims made against those professionals are utilized in other claims against the professional.

These consent clauses are especially well known in medical malpractice cases, but they also play a role in claims against many other professionals.

The language used by the insurance industry in the "consent" clause varies, but one of the more popular iterations of the clause reads:

> We may investigate and solicit settlement offers for any "claim." No offer to settle a "claim" will be accepted without your written consent.
>
> If we recommend that you accept the judgment of the trial court, appellate court, any negotiated settlement or settlement offer, and you are not willing to accept such judgment or settlement, our liability for such "claim" shall not exceed the amount we would have paid for "damages" and "claim expenses" incurred up to the time we made the recommendation, providing such amount does not exceed the remainder of the applicable limit of liability. We shall thereafter be relieved of any additional liability under this Policy, including the duty to defend.

This is known in the insurance industry as a "Hammer Clause." So named, because of the power it gives the insurer over an insured defendant, like a hammer has over a nail. (A Hammer Clause is also known as a blackmail clause, settlement cap provision or consent to settlement provision.)

Powerful tools the clause gives to the insurer

First, if the insurer wants to settle a case, and the insured refuses to consent, the policy limits actually drop to the amount of the settlement proposed by the insurer.

Second, the insurer is "relieved" of its legal obligation to defend the insured, meaning that the insured (who is withholding consent to authorize the settlement) becomes liable for the costs of defense from the time that he or she refuses to consent to the settlement

Copyright © 2018 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**



proposed by the carrier. This is an extraordinary power that the insurer has over its own insured, because of the horrific consequences which can result if the insured vetoes a settlement.

A hypothetical example of how the Hammer Clause benefits an insurer, and how it harms an insured, illustrates its power:

Assume a case with $1 million burning limits. ("Burning limits," also typical in professional liability policies, reduce the policy limits as defense costs are incurred.) Assume further that there is an insurer-recommended settlement of a claim for $200,000, and $100,000 in defense costs. And assume, finally, that the insured did not consent to such a settlement of $200,000. Invoking the Hammer Clause would cap the available policy limits for the insured, from $900,000 (which is the $1 million policy limit minus the $100,000 defense costs), to $300,000 (the total of the recommended offer, plus the defense costs).

The costs to the insured, for withholding consent to the settlement offer, are astounding: *$600,000 would come off of the original policy limits, and the insured would assume all additional liability for the defense costs from the time it rejected the settlement.*

An insured who rejects an insurer-proposed settlement offer presents an enormous opportunity for an insurer to profit from the supposed intransigence of its own insured.

But that is not all.

All "claim expenses" (i.e., attorney fees) become the obligation of the insured from the point in time that the settlement recommendation is made by the insurer. (This is because the policy says that the insurer's liability "shall not exceed the amount *we would have paid* for "damages" and "claim expenses.")

So, continuing with the example, the insured not only relinquishes $600,000 in policy limits, but it also assumes unlimited liability for all defense costs from that point in time, until the case is finally resolved. And this is true regardless of whether the insured "wins" or loses the case.

If, for example, the case proceeded to trial, and there was a judgment of $100,000 (which is $100,000 less than the hypothetical offer), that would certainly be considered a "win" for the defense. Not so.

The insured, because he or she had not consented to the offer the carrier wanted to make, still has to pay all attorney fees and costs that its side had incurred since the proposed settlement had been vetoed. So, the insured is badly bruised by this "win," because it must pay for those attorney fees.

And, if the judgment came in for an amount greater than the proposed settlement offer?

For our example, assume that a verdict was $500,000. That is a nightmare for the insured, since it has to pay $300,000 (the difference between $500,000 and the proposed $200,000), plus all of the attorney fees and costs.

It is easy to see why insurance companies like these provisions in their professional liability policies. It has the potential for extraordinary savings for the insurer, all to the detriment of its insured.

The Hammer Clause is illusory

This example demonstrates why commentators conclude that Hammer Clauses make consent "illusory" for the insured. ("Most professional liability policies qualify their settlement provisions so as to avoid the insured's impetuousness at the insurer's expense. The qualification may, as a practical matter, make the right to withhold consent illusory." (California Insurance Law & Practice (2017), Hinshaw & Culbertson LLP, § 46:10.)

In reality, it is a nuclear option available to an insurer ("blackmail" as noted by one commentator above) to swat away a "consent" clause which the insured likes to think is advantageous, but which is chimerical.

Other courts have agreed that the Hammer Clause can result in drastic consequences for the insured, leading some to question its implementation.

> "[t]he insured's refusal to consent to a settlement, however reasonable, would deprive the insured of the full indemnification protection for which he contracted. In addition, it would deprive the insured of the right to be defended by the insurer because the second sentence of the paragraph upon which NEIC relies would allow NEIC to withdraw from further defense."

(*Clauson v. New England Ins. Co* (254 F.3d 331 (1st Cir. 2001), at 337).)

No rational insured would voluntarily agree to expose itself to hundreds of thousands of dollars in previously insured exposure, allowing its paid-for policy limits to be slashed by its own insurer, and assuming unlimited legal fees that previously had been the insurer's responsibility.

The cases which interpret the "Hammer Clause" reluctantly enforce it, while noting the extraordinary powers it provides to the insurer over the insured. Although an unpublished decision, *Painewebber Real Estate Securities, Inc., v. Fireman's Fund Insurance Company, Inc.*, 1997 WL 33919954 (First District California Court of Appeal) accurately summarized the state of the law with respect to Hammer Clauses:

> In 1979, *Transit Casualty Co. v. Spink Corp.* (1979) 94 Cal.App.3d 124, 136, 156 Cal.Rptr. 360, which involved an excess insurer, held: "There is however a public interest in extrajudicial settlement of lawsuits. [Citations.] The settlement clause [i.e. Hammer Clause in that case] tends to defeat that interest and therefore will be narrowly construed so as not to defeat the covenant of good faith and fair dealing which is an implied reciprocal term of the policy. That covenant contemplates that neither party will injure unreasonably, and certainly not arbitrarily, the right of the other to receive the benefit of the agreement or to minimize a loss thereunder. [Citation.] [¶] Thus the settlement clause does not permit

Copyright © 2018 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**



unreasonable rejection of settlement by the insured." This portion of *Transit Casualty* was affirmed by the Supreme Court in *Commercial Union Assurance Companies v. Safeway Stores, Inc.* (1980) 26 Cal.3d 912, 921, 164 Cal.Rptr. 709, 610 P.2d 1038, and *Signal Companies, Inc. v. Harbor Insurance Co.* (1980) 27 Cal.3d 359, 365, 165 Cal.Rptr. 799, 612 P.2d 889. Other portions were disapproved.

The California Supreme Court has, as the preceding quotation illustrates, taken the opportunity to consider the circumstances when insurers have attempted to use the Hammer Clause to their advantage. The court permitted the clause to be utilized, but it also reached remarkable conclusions about its use. In *Commercial Union Assurance Companies v. Safeway Stores, Inc.* (1980) 26 Cal.3d 913, the court wrote, at page 918:

> One of the most important benefits of a maximum limit insurance policy is the assurance that the company will provide the insured with defense and indemnification for the purpose of protecting him from liability. Accordingly, the insured has the legitimate right to expect that the method of settlement within policy limits will be employed in order to give him such protection.

When courts are confronted with insurers who are loath to make settlement offers, allegedly based upon the alleged refusal of their insureds to consent, the consequences for the insurers are not good. In *Garner v. American Mut. Liability Ins. Co.* (1973) 31 Cal.App.3d 843, the insurer maintained that its hands were tied because the insured relied upon a clause in the policy which required the consent of a review board before settlement offers could be extended.

The Court of Appeal reversed the trial court's judgment in favor of the insurer, and ruled that the insurance company had an independent obligation to assess the merits of the case, notwithstanding the consent clause. Because it failed to independently assess the merits of the case, the insurer was responsible for the loss up to its policy limits. The court stated, at page 849:

> Defendant carrier owed to plaintiff, as it owes to each insured member of the Sacramento County Medical Society, its independent evaluation of the risk to which plaintiff was exposed by reason of the malpractice litigation.

So, what is the bottom line?

Courts do enforce Hammer Clauses, albeit reluctantly, and they do recognize the extraordinary consequences that can occur if the insured defendant withholds consent to offers that the carrier wants to make.

But, as we will see, that pales in significance to the other consequences of the Hammer Clause.

Significant ethical problems for panel counsel

As noted above, strict adherence to the Hammer Clause means that the insured defendant becomes liable for legal fees, after he or she has refused to consent to a settlement recommended by the insurer. But the problems do not end there. The Hammer Clause places panel counsel, retained by insurers to defend its insureds, in a conflict which cannot be resolved. On the one hand, retained counsel has obvious loyalties to the insurer, to advocate its interests in resolving the litigation for the lowest possible sum.

On the other hand, the duty to the defendant/insured is to remove the client from the litigation, without it having to make any financial contribution to a settlement or judgment. Thus, the insured wants the insurance company to make offers of settlement, up to and including the policy limits, so that the case is settled.

That particular conflict – between the carrier's desire to pay the least, and the insured's desire that the carrier pay up to its policy limits – is not unique. Indeed, that divergence is inherent in any insurer/insured relationship in which claims are being defended by an insurer through defense counsel.

What is different – when a Hammer Clause is contained in the policy – is the dramatic effect that it has upon the financial consequences for the insured, and the corresponding opportunities for an enormous windfall for the insurer.

In a typical case, where no insured consent is mandated by the policy and there is no Hammer Clause, the financial consequences to the insured remain unchanged (complete protection up to policy limits) and the insurer has no incentive to have its insured consent to a settlement amount that still does not resolve the case (because there is no reduction in policy limits when the offer does not settle the case).

Because of the Hammer Clause, however, panel counsel has a duty to inform its insured client about the severe financial consequences when the insurer makes a settlement recommendation. In that situation, the insurance company wants either of two alternatives, both of which offer incredible financial benefits:
(1) a settlement at something less than policy limits, or
(2) a rejection of its recommendation by its insured, locking in lower policy limits.

For the insured, its legal path is obvious. Any lawyer representing that insured is going to recommend that the insured *not* relinquish its paid-for coverage. The consequences are simply far too drastic. (Indeed, it is likely beneath the standard of care for an attorney to recommend that an insured defendant voluntarily assume what has become uninsured exposure, both in terms of a reduced policy limit, and unlimited exposure to future defense costs.)

The first of two opportunities for the plaintiff's lawyer

The clauses lay to waste a claim by the insurance company that the insured is unreasonably withholding consent to

Copyright © 2018 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**



settlement offers by the carrier. Any insured who has actually been *told* about the Hammer Clause is not going to withhold consent. The adverse consequences are simply far too harsh.

So, the focus of the settlement negotiations can return to the ordinary issues in any claim: liability and damages.

But there is a second opportunity presented by Hammer Clauses that creative plaintiff lawyers might exploit, from the very beginning of the case, to force the insurer into costly decisions about defending the claim. These involve ethics rules that create significant problems for counsel hired by the carrier to defend the insured.

If an insurer relies on a Hammer Clause, argue that it must retain independent counsel. A conflict of interest occurs when the lawyer's duty toward one client requires the lawyer "to contend for that which the duty to another client requires [the lawyer] to oppose." (*Flatt v. Superior Court* (1984) 9 Cal.4th 275, 282 fn. 2.)

The court in *San Diego Federal Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358 court observed that an attorney having a dual agency status is subject to the rule that:

> [A] conflict of interest between jointly represented clients occurs whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other." (*Id.*, at 365, fn. 4.)

California Civil Code section 2860 addresses insurance defense conflicts of interest and requires insurers to retain counsel directly for the insured when certain circumstances are met. These include where there is a significant, not merely theoretical, conflict of interest; where the conflict is actual and not merely potential. (*Dynamic Concepts, Inc. v. Truck Ins. Exchg.* (1998) 61 Cal.App.4th 999.) "The potential for conflict requires a careful analysis of the parties' respective interests to determine whether they can be reconciled . . . or whether an actual conflict of interest precludes insurer appointed defense counsel from presenting a quality defense for the insured." (*Id.* at 1007-08.)

Although section 2860 is fairly specific concerning its application, it is not an exclusive list of circumstances in which it applies. As the court stated in *Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal.App.4th 1372, 1395:

> The language of Civil Code section 2860 "does not preclude judicial determination of conflict of interest and duty to provide independent counsel such [20 Cal.App.4th 1396] as was accomplished in *Cumis* so long as that determination is consistent with the section." (*United States Fidelity & Guaranty Co. v. Superior Court* (1988) 204 Cal.App.3d 1513, 1525 [252 Cal.Rptr. 320].) fn. 5.

In *Golden Eagle,* the court found that the conduct of an insurer had the effect of exposing its insured to a legal money judgment, which it did not have the authority to do. In the course of making that finding, the court ruled that the insurer was responsible for the costs incurred by the insurer's personal counsel in defending the insured.

So, these rules provide the foundation for an argument that the Hammer Clause itself creates a conflict for panel defense counsel, such that the insurer should retain separate independent counsel, who would personally represent the insured. There do not appear to be any published decisions which actually reach this conclusion. But that does not mean that the enterprising attorney who spots this issue has no arrows in his or her quiver.

There is, for example, an unpublished case in the Central District of California, in which the court issued an opinion concerning a Hammer Clause that discussed the circumstances in which it can be invoked. In the process of discussing that clause, the court noted the consequences to an insured who faced the prospect of moving ahead when its insurer no longer had a legal responsibility to fund the continued defense of the insured.

In that case, *Freedman v. United National Ins. Co.* 2011 WL 7811919 (Central Dist., California, 2011), the court wrote at footnote 2:

> Thus, the insured would be faced with the prospect of bearing the cost of any defense moving forward – and the vigor of the carrier's advocacy could well be diluted. If so, that would be *almost as disruptive as having no counsel*. [Emphasis added.]

That is one of two arguments that plaintiff lawyers can make:

The first is that, in the event that an insurer elects to rely upon the Hammer Clause, it will be effectively depriving the insured of counsel. (*Freedman, supra.*) Before taking such a drastic step, the insurer must retain independent counsel for its insured, who can provide advice without the conflicting duties which confront any panel counsel retained by the insured.

The second is that, because of the Hammer Clause, panel defense counsel potentially has these conflicting duties: Advocate for its insured/defendant client that it should consent to any settlement that might be recommended by the insurer, because that is in its best financial interest; and Advocate for its client that it should make the lowest possible settlement, while fully aware of what happens if the defendant/insured vetoes that settlement pursuant to the Hammer Clause.

When do these conflicts manifest themselves?

Good question. No case has been located which discusses this.

The most aggressive position would be that the conflict arises the moment a claim is made against an insured who has a policy that contains a Hammer Clause.

And the reason for this is that any lawyer retained by a carrier immediately has the conflict of (1) working the case in such a way that its insured/defendant client is insulated

Copyright © 2018 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**



from all claims, regardless of the cost, and (2) achieving the insurer's goal of spending the least amount of money, which would include having the insured/defendant reject a potential settlement that drops the limits to that level, as well as shifting the defense obligation from insurer to insured.

Get the insurance policy early

In real life, these issues generally do not manifest themselves until there are settlement negotiations, which is when the harsh realities of the different motivations can dominate the conversation.

But that does not mean that they are not present far earlier in the case, which is another reason that plaintiff lawyers who get copies of all applicable policies early in the case, (and then actually read them), can be in a position to write to defense counsel pointing out this problem.

That tactic may not result in any immediate response, but it plants the seed of a problem. At the least, it virtually mandates that defense counsel advise the insured that it really has no "consent" power at all, because of the amazingly harsh penalties that await it, if the insured refuses to consent. This removes the belligerent insured/defendant as a problem, which, in turn, will mean that your mediator won't come to you early in the mediation and say "sorry, the defendant refuses to consent to any settlement."

The plaintiff attorney can avoid the problem which confronted the lawyer representing the plaintiff in the case mentioned at the beginning of this article.

It was a real case. But after the failed mediation, when the arguments discussed here were submitted to the insurer, the carrier went from offering zero (ostensibly because of no consent), to offering the $1 million policy limits.

All in one week.


Stannard

Greg Stannard is a former attorney with nearly 30 years of experience trying cases, particularly cases concerning insurance coverage and bad-faith issues. He now provides coverage and bad-faith consulting exclusively for plaintiff attorneys so that they can maximize coverage for their cases. His website is onlyforplaintiffs.com.

Copyright © 2018 by the author.
For reprint permission, contact the publisher: **www.plaintiffmagazine.com**