Validity of the "Pay and Walk" Provision of a Liability Insurance Policy

By Michael D. Wade and Tara L. Velting

A liability insurance policy provides monetary protection in case of liability up to a certain amount and certain additional protections such as defense costs (e.g., attorney fees and litigation costs). Before 1966, the standard liability policy contained defense clause language such as:

> With respect to such insurance as is afforded by this policy, the company shall (a) Defend any suit against the insured alleging such injury, sickness, disease or destruction and seeking damages on account thereof even if such suit is groundless, false or fraudulent; but the company may make such investigation, negotiation and settlement of any claim or suit as it deems expedient; . . . . And the amount so incurred, except settlements of claims and suits are payable by the company in addition to the applicable limit of liability of this policy.[1]

In 1966, the standard policy was changed to combine the indemnity and defense clauses and expressly define the insurer's right to terminate the defense of the insured upon payment of the policy limits. The new language reads similar to the following:

> The insurer shall not be obligated to pay any claim or judgment or to defend any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.[2]

This provision of the current policy is sometimes referred to as the "pay and walk" provision. This article considers cases addressing the validity of language limiting the defense to the time before the exhaustion of policy limits in a historical context, looking at cases both pre- and post-1966. It also addresses cases noting the various permutations in policy

language as well as the variety of circumstances under which claims arise. The exhaustion of policy limits is a centerpiece of attention.

Because no published or unpublished Michigan cases exist on this topic, we recommend how Michigan courts might decide the issue of the validity of this pay and walk provision.

Pre-1966 policy language

The pre-1966 policy did not explicitly contain pay and walk language, but did make defense of the insured subject to the "limits of liability, exclusions, conditions and terms of the policy." This (or similar) verbiage has been found to permit an insurer to withdraw its defense upon payment of policy limits. In *Denham v LaSalle-Madison Hotel Co*, a hotel fire damaged property belonging to 250 guests, but since

At a Glance

An insurer's duty to defend ceases after the policy limits are exhausted.

Settlement must be made in good faith.

An insurer may not prejudice the rights of the insured.

the duty-to-defend language in the policy was limited by the phrase "as respects insurance afforded by this policy," the insurer was only obligated to defend until its limits were "tendered."[3] The court held that when no further insurance was afforded, the obligation to defend was terminated.[4] The court reasoned that the alternative result would produce the "incongruous" situation where the insurer would have a continuing obligation to defend, notwithstanding that its obligation to pay had been exhausted.[5]

In *Lumbermen's Mutual Casualty Co v McCarthy*, the insurance limits were not merely tendered, but a judgment actually paid.[6] The case involved an auto accident that led to two lawsuits. The first went to trial and resulted in an over policy limits judgment that was paid to the policy limits by the insurer, which then sought a declaration that it had no duty to defend the second suit. Recognizing that the duty to defend was independent of the duty to pay, the court found that the primary duty imposed on the insurer was to pay the insured's legal liability for damages. The court stated:

> As we construe the policy it obligates the insurer to pay the liability of the insured up to the policy limits, and in addition thereto to pay those items of expense which it has definitely assumed. Until these duties of payment are fully performed, it also has the duty either to settle or to conduct the defense of actions against the insured. But upon performance of its duties of payment its duty to defend ceases to exist and the further defense of any action pending thereafter must be conducted or may be controlled by the insured.[7]

The court cautioned that an insurer may not abandon its defense of a claim in midcourse and under circumstances that are prejudicial to the insured. The insurer must defend "in good faith and with due diligence."[8]

Other cases interpreting the pre-1966 policy created a continuing duty to defend after exhaustion of the policy limits. When the policy read, "As respects such insurance as is afforded by the other terms of this policy under coverages A and B [for bodily injury and property damage] the company shall (a) defend…," the court in *American Casualty Co v Howard* held that a continuing duty to defend existed under South Carolina law after payment of the bodily injury policy limits.[9] The court found the insuring agreement ambiguous regarding whether the insurer can terminate its defense upon payment of policy limits, and furthermore, the new claim added a property damage claim for which payment was offered but not actually paid.[10] Other cases agreed with *Howard* that the policies at issue did not unambiguously permit the insurer to withdraw upon payment of policy limits.[11]

Post-1966 policy language

In 1966, the standard form liability policy was revised to place the duty to indemnify and the duty to defend in the same paragraph.[12] That revision also added the following to the duty to indemnify language:

> …but the company shall not be obligated to pay any claim or judgment or to pay any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.[13]

This language was meant to clarify that an insurer's duty to defend ceases after the policy limits are exhausted either by payment of judgments or settlements.[14] Some policies go further to add to the above language "or after such limit of the company's liability has been tendered for settlements."[15] This refinement appears to permit a tender into court of the policy limits and has been held to terminate the duty to defend, but only if the insured has adequate notice of the policy provision.[16]

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The more common provision is the pay and walk language without the added "tendered for settlement." Indeed, the pay and walk verbiage has been construed to permit payment into court, even without "payment of judgments or settlements." In *Farmers Ins Co v Mitchell*, several individuals were injured in an auto accident; the insurer filed an interpleader action seeking to deposit its policy limits into court and requesting a declaration that it had no further duty to defend.[17] The policy provided that the insurer "will not defend any suit or make any additional payments after we paid the limit of liability for coverage."[18] The court held that under the terms of the policy, the insurer had no further duty to indemnify or defend, although the claims totaled more than double the policy limits.[19]

Farmers Ins Co may be an anomaly given the broad policy language, i.e., no duty to defend after "we paid the limit of liability." The usual language of the pay and walk provision relates to "payment of judgments or settlements" and is narrower than "pay the limit of liability." A payment into court is not the same as paying a judgment (for a satisfaction of judgment) or settlement (for a release). Thus, the usual pay and walk provision may not be construed as terminating the duty to defend by paying the policy limits into court in an interpleader action.

One court has considered a covenant not to execute in favor of the insured to be sufficiently like a settlement to relieve the insurer of the duty to defend.[20] The court in this case held that while the covenant not to execute was not a full release, it was sufficient under the circumstances and the primary insurer was relieved of the duty to defend. The court also held that an insurer cannot simply pay its policy limits to a claimant without obtaining any type of release or covenant.

In *Conway v Coventry Casualty Ins Co*, the plaintiff was injured in an auto accident; the defendant paid its policy limits but obtained no release or other covenant.[21] The insurer also refused to defend the continuing lawsuit. The insured hired its own attorney, defended, and settled, and then sought reimbursement from the insurer. The court observed that the insurer was relieved from defending when it paid its limits for "judgments or settlements," but simply paying limits without more, such as a release, does not comport with the policy language. The insured was entitled to recovery.[22]

Most courts have found the pay and walk provision to be unambiguous,[23] but some courts have found other ambiguities. For instance, in *Brown v Lumbermen's Mutual Casualty Co*, the policy provided that the duty to defend terminated when the limits of liability have been exhausted.[24] The insuring agreement also stated that the insurer would "settle or defend" any claim or suit.[25] The court found no ambiguity in the word "exhausted," but did find an ambiguity concerning how the limits might be exhausted, e.g., the insurer might interplead the limits into court, settle for a release of the insured, pay a judgment, pay the limits to the insured, or pay the limits to a claimant for a release of the insurer only.[26] Since there is an ambiguity in the manner of how limits might be exhausted, that ambiguity must be construed in favor of the insured; the duty to defend must continue until the limits are exhausted by way of settlement of claims against the insured or until judgment against the insured is paid.[27]

Regarding the *Brown* case, one might inquire why the court sought so hard to find an ambiguity when the policy language itself was sufficient for the court's reasoning. The policy required the insurer to defend or settle until the limits were exhausted. No term is ambiguous. The insurer obtained a release for itself and did not defend its insured. *Pareti v Sentry Indemnity Co* makes it clear that the "defend or settle" provision applies to the insured, not the insurer without reference to the insured. The settlement must be made in good faith and in the best interest of the insured.[28] Any payment made by the insurer that does not release the insured from a pending claim—even a policy limits payment—is possibly in bad faith.[29] One court has concentrated on the duty to pay under the policy, and in an interpleader case held that the duty to defend is not terminated by paying money to be held by the court because the insurer has not surrendered the money (by admitting liability) nor has it fulfilled any obligation owed by

the insured, as both elements are necessary to pay money under the insurance policy.[30]

In terminating a defense, an insurer must do so in a manner that does not prejudice the rights of the insured.[31] The insurer has the obligation to do the following to fulfill its duty to defend before terminating the defense of an insured:

- Determine coverage and potential liability;
- Exhaust policy limits by payment of a judgment or settlement;
- Satisfy the terms of the policy;
- Not act contrary to public policy;
- Not be in bad faith; and
- Provide notice to the insured of the insurer's right to terminate.[32]

An insurer may not abandon its defense of a claim midcourse and under circumstances that are prejudicial to the rights of the insured.[33]

Conclusion

Within the constraints described above, the post-1966 language in the liability policy intends (and most courts permit) insurers to pay and walk.[34] Surprisingly, no Michigan court has yet decided the validity of the pay and walk provision. One unpublished opinion in Michigan has applied the pay and walk contract term without a discussion of its validity and in the context of allocation of costs among primary and excess insurers.[35] We recommend that insurers in Michigan might find it advantageous in an appropriate case to exercise the pay and walk policy language. The key to the validity of pay and walk is the proposition that courts will enforce clear and unambiguous provisions of the insurance policy as written. Michigan subscribes to that rule of contract construction.[36] ■

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ENDNOTES

1. 27 ALR 3d 1057 § 2[a].
2. 16 ALR 6th 603 § 2.
3. *Denham v LaSalle-Madison Hotel Co,* 168 F2d 576, 584 (CA 7, 1948).
4. *Id.* at 585.
5. *Id.*
6. *Lumbermen's Mutual Casualty Co v McCarthy,* 90 NH 320; 8 A2d 750 (1939).
7. *Id.*, 8 A2d at 752.
8. *Id.*
9. *American Casualty Co v Howard,* 187 F2d 322 (CA 4, 1951).
10. *Id.* at 326.
11. *Kocse v Liberty Mutual Ins Co,* 159 NJ Super 340; 387 A2d 1259 (1978) (where cases are collected); *American Employers Ins Co v Goble Aircraft Specialties, Inc,* 131 NYS2d 393 (1954) (to terminate upon payment of policy limits, policy must unambiguously so state); and *Anchor Casualty Co v McCaleb,* 178 F2d 322 (CA 5, 1949) (under Texas law, nothing in policy permits paying into court policy limits to avoid defending).
12. *Gross v Lloyds of London,* 121 Wis 2d 78, 83; 358 NW2d 266 (1984).
13. *Id.* at 83–84.
14. *Id.* at 84.
15. *Id.* at 83.
16. *Id.* at 89 (language must be highlighted in policy actually received by the insured).
17. *Farmers Ins Co v Mitchell,* 755 F Supp 255 (WD Ark, 1989).
18. *Id.* at 256.
19. *Id.* See also *Viking Ins Co v Hill,* 57 Wash App 341; 787 P2d 1385 (1990) (insured signed a release on duty to defend).
20. *Continental Casualty Co v Farmers Ins Co,* 180 Ariz 236; 883 P2d 473 (1994).
21. *Conway v Coventry Casualty Ins Co,* 92 Ill 2d 388; 442 NE 2d 245 (1982).
22. *Id.* at 399–400.
23. *Johnson v Continental Ins Co,* 202 Cal App 3d 477, 482 (1988) and *American States Ins Co v Arnold,* 930 SW2d 196, 201 (Tex, 1996) (language is precise, plain, and clear).
24. *Brown v Lumbermen's Mutual Casualty Co,* 326 NC 387, 393; 390 SE2d 150 (1990).
25. *Id.*
26. *Id.*
27. *Id.*
28. *Pareti v Sentry Indemnity Co,* 536 S2d 417, 423 (La, 1988).
29. *Id.* at 424.
30. *American Standard Ins Co v Basbagill,* 333 Ill App 3d 11; 775 NE2d 255 (2002).
31. *Allstate Ins Co v Montgomery Trucking Co,* 328 F Supp 415 (ND Ga, 1971).
32. *St. John's Home of Milwaukee v Continental Casualty Co,* 147 Wis 2d 764; 434 NW2d 112 (1988).
33. *Lumbermen's Mutual Casualty Co,* 8 A2d at 752 and *Continental Casualty Co v Synalloy Corp,* 667 F Supp 1523, 1536 (SD Ga, 1983).
34. Personal-injury plaintiff attorneys call this provision pejoratively "dump and run," *Mt. Hawley Ins Co v Mesa Medical Group,* 267 F Supp 3d 955, 958 (ED Ky, 2017).
35. *Westfield Ins Co v Allstate Ins Co,* unpublished opinion per curiam opinion of the Court of Appeals, issued June 21, 2012 (Docket No. 295486).
36. *Coates v Bastian Brothers, Inc,* 276 Mich App 498, 503 (2007) and *Rory v Continental Ins Co,* 473 Mich 457, 468 (2005).