

INSURERS' POTENTIAL LIABILITY TO THIRD PARTIES FOR NEGLIGENT INSPECTIONS

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Introduction

In their perennial search for viable deep-pocket defendants, personal injury plaintiffs' lawyers can be very creative, requiring insurers and their counsel to respond to theories of liability that challenge common assumptions in the industry. Some courts, wishing to do what they see as "substantial justice," eagerly embrace such theories, compounding the industry's difficulties. One example of plaintiffs' creativity is their recurrent — and often successful — efforts to hold insurers liable for allegedly negligent underwriting and loss prevention inspections.

Such efforts are often made when a plaintiff injured in the course of employment wants compensation greater than the scheduled benefits provided by workers' compensation. Typically in such cases the injured employee will sue a readily predictable defendant other than his employer: the owner and operator of a vehicle, the manufacturer of an allegedly defective and unreasonably dangerous machine, the engineer who designed allegedly dangerous premises, the owner and general contractor of a construction site, *etc.* But what if the would-be plaintiff cannot identify a viable defendant, either because there is no potential defendant other than the employer, or because all obvious candidates for the role are judgment-proof and un- or under-insured? In such instances, some plaintiffs have brought actions directly against the employer's workers' compensation, general liability, or property insurers, alleging the insurer(s) performed negligent inspections of the subject premises, operations, or instrumentality. In bringing such cases, plaintiffs hope to find not only a solvent defendant, but one whose realistic exposure is not capped by policy limits: *i.e.*, the insurer's potential exposure in such cases may extend well beyond the limits of the insured employer's policy.

Most in the industry regard such inspections as conducted for purposes of the insurer's underwriting and loss prevention efforts, and not for the benefit of either the insured or third parties. Nevertheless, such claims generate a fair amount of litigation and judicial opinion-writing, with mixed results for insurers. The courts' treatment of such claims tends to be fact-specific, but a number of lessons emerge. Those lessons should be borne in mind by insurers who wish to insulate themselves from this kind of claim to the extent possible.

General Factual Background

As part of their underwriting and loss control activities, many commercial property and casualty writers inspect insured locations and operations. Such inspections may be performed by either company-trained loss control inspectors or graduate engineers. Inspections may range from relatively quick, simple, and cursory surveys by lay inspectors (*e.g.*, checking for the presence of an automatic sprinkler system in a single structure) to relatively detailed, thorough, and lengthy surveys — performed by graduate engineers or other appropriate specialists — of many technical aspects of large, complex manufacturing facilities. Inspectors also often gather impressions of the insured's attitude, cooperativeness, knowledge, and commitment to loss prevention and control.

After performing such an inspection, the inspector typically prepares for the insurer a written report, which may or may not include suggested recommendations for how the policyholder (or prospect, if the business has not yet been written) might improve its loss experience, and therefore the profitability of the insurer's business. In most instances, copies of such reports are forwarded to the policyholder, so it may consider and perhaps act on the inspector's suggested recommendations. In some cases, issuance or renewal of a policy may be contingent on compliance with some recommendations, called *mandatory* recommendations.

Such inspections are typically performed to help underwriters place profitable business on their books, and to maintain and enhance the profitability of that business while it remains in force. Inspections contribute to those goals by (a) helping the underwriter evaluate the hazards for which the insurer could be liable under its policy, (b) helping the insurer formulate recommendations that, if accepted and acted upon by the insured, are believed likely to improve the insured's loss experience, and therefore the insurer's profit from the business, and (c) updating the insurer's general background information about insured locations and operations for its own internal research purposes. The loss control inspector's activities are therefore typically directed to those ends, and not to advising the insured generally on matters affecting the safety of its personnel *per se*: if an underwriting or loss prevention inspection results in improved personal safety that is fine, but it is merely an incidental by-product of the inspection's actual purpose of improving the profitability of the insurer's business.

The inspection function is therefore regarded by insurers as essentially self-serving, performed for insurers' own benefit, and not for the benefit of either policyholders or third parties (although an unavoidable, incidental by-product may be to benefit policyholders and third parties). In recognition of the self-serving nature of such inspections, many policies typically contain a provision substantially similar to the following:

The Company shall be permitted but not obligated to inspect the Insured's property and operations at any reasonable time. Neither the right to make inspections nor the making thereof, nor any advice or report resulting therefrom shall constitute an undertaking on behalf of or for the benefit of the insured or others, to determine or warrant that such work places, operations, machinery or equipment are safe.

Even if the policy is silent as to inspections, inspection reports and recommendations sent to insureds often contain disclaimers, such as the following:

The recommendations listed are made with the belief that, if followed, they will

lessen the possibility of loss to your property. We can accept no responsibility for their completeness or effectiveness, but we consider them important and hope you will comply with them.

Plaintiffs' Theories

Plaintiffs with so-called negligent inspection claims typically do not allege a statutory cause of action, since there is usually no statute imposing on an insurer a duty to perform inspections. Nor do they allege that the insurer has a common law duty to inspect the insured's premises or operations, since there usually is no such duty. Plaintiffs also typically do not claim that the insurance contract creates or imposes on the insurer a duty to inspect, since most insurance contracts either explicitly provide to the contrary or are silent on the subject.

Rather, plaintiffs in such actions generally claim that the insurer, by inspecting the premises *at all*, incurs a duty to the policyholder, the policyholder's employees, and even members of the general public lawfully on the insured's premises or using the insured's products or equipment. The nature of that claimed duty is to exercise reasonable care in conducting the inspections, including the duty to identify and bring to the insured's attention — and perhaps to the attention of others — all reasonably identifiable conditions posing a risk of personal injury.

That kind of claim is based on an oft-quoted maxim that "one who assumes to act, even though gratuitously, may thereby become subject to the duty of acting carefully, if he acts at all." (*Glanzer v. Shepard*, N.Y. Ct. App., 1922) That and similar statements have been synthesized in § 324A of the Restatement (2d) of Torts:

§ 324 A. Liability to Third Person for Negligent Performance of Undertaking.

One who *undertakes*, gratuitously or for consideration *to render services to another* which

he should recognize as necessary for the protection of a third person or his things, is subject to liability to the third person for physical harm resulting from his failure to exercise reasonable care to protect his *undertaking*, if

- (a) his failure to exercise reasonable care *increases the risk of harm*, or
- (b) he has *undertaken* to perform a duty owed by the other to the third person, or
- (c) the harm is suffered because of reliance of the other or the third person upon the *undertaking*.

(Emphases added.)

Based on that common law doctrine (sometimes referred to as the "Good Samaritan Rule"), plaintiffs often urge that a bare-bones negligent inspection case need include only the following elements: that (a) the defendant insurer inspected the premises, (b) the inspection was negligent, in that it failed to detect a particular peril to life and limb, (c) the particular peril thereafter occurred, and (d) as a result, the plaintiff was rendered sick, sore, lame, and disabled. If a court forces them to do so, plaintiffs will also allege, and try to prove, that either (e) the inspector's failure to exercise reasonable care increased the risk of the harm, or (f) the inspector undertook to perform a duty owed by the policyholder to the plaintiff, or (g) the harm was suffered because of the policyholder's or plaintiff's reliance on the insurer's inspection.

The Requirement of an Undertaking

In attempting to reduce their claims to that simplistic formula, plaintiffs often ignore a major threshold requirement to the applicability of § 324A: *that the insurer have undertaken to render services to another, which the insurer should recognize as necessary for the protection of a third party or his things*. The requirement of an "undertaking" is usually an insurer's first line of defense in negligent inspection cases. In this context, the insurer should argue that an "undertaking" means an actual assumption of responsibility to perform a service principally for the benefit of another.

The insurer's classic position is that its inspection of the insured's premises or operations was

conducted for the insurer's own benefit, as part of its routine underwriting and loss prevention practices, and did not constitute an "undertak[ing] to render services to another." In support of that position, the insurer will wish to point to (a) the industry's customary understanding of such inspections, (b) the insurer's own intent, (c) policy language expressly denying any undertaking, and (d) the insurer's disclaimers on its inspection reports. Those arguments have been successful in many cases. *E.g.*, *Jansen v. Fidel. & Cas. Co. of N.Y.*, N.Y. Ct. App. (1992); *Smith v. Allendale Mut. Ins. Co.*, Mich. Sup. Ct. (1981); *Riverbay Corp. v. Allendale Mut. Ins. Co.*, U.S.D.C., S.D.N.Y. (1988); *Leroy v. Hartford Steam Boiler Insp. & Ins. Co.*, U.S.D.C., D.Kan. (1988). Plaintiffs often urge that the mere act of inspecting, by itself, betokens an undertaking within the meaning of § 324A. Insurers therefore tend to do best in negligent inspection cases when they keep the court's attention firmly focused on the nature of the insurance relationship and the insurer's self-serving purposes in inspecting, as expressed and limited by the policy language.

Some courts effectively eliminate the undertaking requirement, either by ignoring it altogether, or by holding that inspections with the dual effects of helping the insurer's underwriting and helping the insured prevent accidents are necessarily undertakings for the benefit of the insured, and that any benefit derived by the insurer from such an inspection does not remove it from the scope of § 324A. Other courts engage in fact-sensitive inquiries to determine if there is evidence of an undertaking.

Evidence of an Undertaking

The Insurer's Advertising

Some courts review the facts for evidence of a specific intent to benefit the insured or third parties, rather than primarily to fulfill the insurer's self-serving purposes. One may not have to look very hard for such evidence, since it is often plentiful in insurers' advertisements, marketing pieces,

and coverage proposals. *E.g.*, *Derosia v. Liberty Mut. Ins. Co.*, Vt. Sup. Ct. (1990); *Pratt v. Liberty Mut. Ins. Co.*, 2d Cir. (1992); *Deines v. Vermeer Mfg. Co.*, U.S.D.C., D.Kan. (1990). Nevertheless, some courts have held that explicit policy language (permitting, but not requiring, the insurer to inspect for its own benefit) controls over any marketing documents that might suggest an intent to benefit the insured. *James v. State*, N.Y. Ct. App. (1983); *Riverbay Corp.*, *supra*.

The Scope of the Inspection

If an inspection can be characterized as more comprehensive, more frequent, or more detailed than needed for underwriting, plaintiffs will argue that that is evidence of an intent to benefit the insured or third parties. A plaintiff might also use such evidence to argue that the inspections were intended to relieve the insured of responsibility for detecting and correcting its own safety problems, in effect transferring to the insurer the employer's responsibility to provide a safe workplace. Also, the broader an insurer's inspections, the more likely they are actually to have encompassed the instrumentality that later caused the injury, thereby helping to substantiate and add persuasive force to the plaintiff's claim.

Even the *name* by which an insurer refers to its inspections may be seized on by some courts as evidence of a purpose to benefit an insured or third parties. *Deines*, *supra* (insurer referred to them as "safety" inspections).

The Type of Coverage

Negligent inspection cases often turn on the kind of insurance for which the inspection was made. Some reported decisions draw sharp — and appropriate — distinctions between third-party liability, workers' compensation, and first-party property coverages in analyzing insurers' responsibility for their inspections. Although no hard-and-fast rules can be stated in this area, there

is a noticeable tendency for workers' compensation and boiler and machinery writers to be treated more harshly than, say, first-party property insurers writing fire coverage. That is because workers' compensation inspections focus on actual personal safety issues, whereas property insurers typically inspect only for covered perils that threaten losses to property (boiler and machinery coverage presents its own special problems, see *infra*). Courts may also feel that, after all, workers' compensation carriers have charged a premium for accepting the risk of workplace injuries, whereas first party property insurers have not.

***The Special Case of Boiler
and Machinery Inspections***

What if an insurer conducts regular inspections of a specific, highly dangerous instrumentality, and provides the insured with a certificate attesting to the fitness of that instrumentality? What if, in addition, that certificate discharges the insured's statutory obligation to inspect the instrumentality, with the insurer's inspections co-extensive with the insured's statutory duty to inspect? What if the insurer's inspector has the authority to suspend the insurance or, in some instances, shut down the dangerous instrumentality if he finds an unacceptable condition? Such facts sound much more like an "undertaking" than an underwriting inspection. That is the problem presented by cases involving boiler and machinery policies.

In many jurisdictions, owners of boilers, pressure vessels, and similar equipment are required by statute to inspect and certify them regularly. The certification is usually required to be performed by a state-approved inspector. Such inspection services are commonly provided by first-party property insurers writing boiler and machinery coverage. Many insureds regard such inspection services as a principal reason for buying boiler and machinery coverage. Under such circumstances, negligent inspection cases arising under boiler and machinery policies often present substantial

evidence of an undertaking, resulting in judicial decisions adverse to insurers.

Workers' Compensation Immunity

Although in some jurisdictions workers' compensation insurers have fared poorly with negligent inspection claims because of the personal safety focus of their inspections, in other jurisdictions they have been largely immunized from such claims, by either judicial decision or legislative action. *E.g.*, *Kifer v. Liberty Mut. Ins. Co.*, 8th Cir. (1985); *Leroy, supra*; *UNR Industries, Inc. v. American Mut. Liability Ins. Co.*, U.S.D.C., N.D.Ill. (1988). At least one state has enacted a statute partially immunizing all insurers, not just workers' compensation carriers, from negligent inspection claims. *A.O. Smith Corp. v. Protection Mut. Ins. Co.*, U.S.D.C., E.D.Wis. (1978).

Other Elements of § 324A

An undertaking is not enough to create liability. At least one of the additional three circumstances listed in Restatement § 324A must also be present. Either (a) the insurer's failure to exercise reasonable care must have increased the risk of harm, or (b) the insurer must have undertaken to perform a duty owed by the insured to the injured third party, or (c) the harm must have been suffered because of reliance of the insured or of the injured third party on the insurer's undertaking.

Increasing the Risk of Harm

Although many decisions say an insurer may be liable if its inspection increases the risk of harm, few plaintiffs make such a claim. Such a claim should arise only when the insurer has done something more than fail to detect a pre-existing hazard: there must be conduct that affirmatively increased the risk of harm. Negligent inspection cases in which an inspector actually increases the risk of harm will be few and far between, and will most likely involve an inspector's

recommendation that turns out to cause harm to third parties. However, one reported decision purported to find an increased risk of harm resulting from nothing more than an inspector's failure to advise an insured to stop using a particular type of plastic pipe. Insurers confronting such allegations should argue that liability for increased harm under § 324A(a) must be based on something other than merely permitting the continuation of a pre-existing risk, and requires a specific factual showing that the insurer's conduct affirmatively increased the likelihood that the harm would occur.

Reliance on the Undertaking

Restatement § 324A(c) provides for liability where "the harm is suffered because of reliance of the other or the third person upon the undertaking." The reliance must be an actual cause in fact of the injury, such as by inducing the insured or third party to forego other remedies or precautions. The element of reliance may be supplied by the reliance of either the "other" (*i.e.*, the insured) or "the third person" (*i.e.*, the injured plaintiff).

The requirement of *actual* reliance was once an obstacle to plaintiffs, because they could seldom prove actual reliance, but that may no longer be the case. In recent cases, some courts have permitted even vague, equivocal, circumstantial, and conclusory evidence of reliance to defeat an insurer's motion for summary judgment or support a plaintiff's verdict. *Deines, supra*; *Phillips v. Liberty Mut. Ins. Co.*, 11th Cir. (1987); *Smith v. Universal Underwriters Ins. Co.*, 11th Cir. (1985); *Huggins v. Aetna Cas. & Sur. Co.*, Ga. Sup. Ct. (1980). In *Smith v. Universal Underwriters Ins. Co.*, the court held, in effect, that an employee's mere *awareness* of an inspection, followed by his continuation of business as usual in the [purely subjective and unfounded] belief that any necessary precautions would be taken or called to his attention, made out a sufficient case of reliance to raise a jury issue! Far from being an obstacle, the element of reliance may now be a highway to recovery in

some jurisdictions.

Insurers confronting claims of reliance should leave no stone unturned in an effort to show that the alleged reliance was unfounded and unreasonable: the more unreasonable, the better. This should be done, first, to demonstrate that the claim of reliance is untrue, because no one could entertain such unreasonable reliance and, second, to try to lay a foundation for arguing that the alleged reliance was so objectively unreasonable that it was not the kind of reliance contemplated by § 324A(c).

Insurers can create helpful evidence of non-reliance by peppering their correspondence with clear statements to the effect that their inspections are neither a part of nor a substitute for the insured's own safety programs, and that the insured and its employees should not rely on the insurer to guarantee them a safe workplace. Such statements can be included in letters scheduling inspection visits or transmitting inspection reports, as well as in general information distributed to policyholders. If there has been such correspondence with the insured before the occurrence of an accident, any subsequent claim of "reliance" by the insured may appear unreasonable and incredible.

Proximate Cause

Nothing in § 324A or the case law dispenses with the requirement that a plaintiff prove that his injury was proximately caused by the defendant. Insurers defending negligent inspection claims should require plaintiffs to prove that, if the inspector had detected the particular hazard and reported it to the insured, then the insured would have timely corrected it. In some cases that may be difficult for the plaintiff to prove.

Any inquiry into proximate cause will be case-specific, but there are some areas the insurer

should consider as a matter of course: Did the policy require the insured to follow the insurer's recommendations, or was the policyholder free to ignore them? Has the insured in fact timely followed each and every one of its insurers' recommendations in the past? Was the dangerous condition at issue already brought to the insured's attention by anyone other than the insurer? Was the particular recommendation at issue already considered and rejected by the insured? Was the particular modification urged by the plaintiff so expensive or disruptive that it would not have been adopted, even if recommended by the insurer? Was the particular modification urged by the plaintiff already required by an applicable code, so the insured should already have been in compliance with it without a recommendation by the insurer? *Etc.*

Public Policy Considerations

Considerations of fairness and public policy provide strong reasons for not imposing liability on insurers absent a clear § 324A undertaking. The reasons of fairness were pithily stated almost thirty years ago by the dissent in *Nelson v. Union Wire Rope Corp.*, Ill. Sup. Ct. (1964):

The result is that an insurer who makes supplemental inspections, designed to minimize potential losses by diminishing the likelihood of injury, is penalized by the imposition of full responsibility for all losses that might have been revealed by the most complete inspection, even though no one concerned relied upon the insurance company for complete inspection.

Further, decisions adverse to insurers will either discourage insurers from performing some inspections (eventually leading to inaccurate pricing and some otherwise avoidable losses), or lead insurers to have more costly inspection programs than necessary for their own purposes, and to pass on those added costs (plus the costs of settlements, judgments, and E&O coverage, if available) to their insureds. Premiums would have to be increased to account for this new, unintended public liability exposure.

Finally, the law should not unnecessarily discourage insurers from making limited inspections for their own underwriting and loss prevention purposes, because even careless inspections detect and cure far more hazards than they miss: even a limited or negligent inspection is better than none at all.

Undecided Issue: How Far Does the Duty Extend?

Assuming that a duty to inspect carefully exists, what does that duty require an insurer to do once it has discovered all reasonably discoverable hazards? To notify the insured of their existence, of course. But what if the insured rejects or ignores the insurer's recommendations? Is the insurer then obligated to communicate its observations and concerns directly to the insured's employees, invitees, and customers? Doing so would probably mean losing customers and inviting litigation for defamation, bad faith, interference with contractual relations, and other claims, but one day a clever plaintiff's lawyer will allege that an insurer has an overriding duty to communicate the information to those most immediately and vitally affected by it: those whose lives are potentially at stake. Until then, the issue remains undecided.

Lessons to Be Learned

The reported decisions in this area go off in a variety of conflicting directions. The applicable law changes from jurisdiction to jurisdiction, making it impossible to reach broad definitive conclusions. Nevertheless, here are some common sense conclusions that insurers wishing to minimize their negligent inspection exposure should consider.

First, if an insurer's policy forms do not include specific language, clearly and

unambiguously stating that any inspection made shall not constitute an undertaking for the benefit of the insured or anyone else, such language should be added. Be aware, however, that some courts ignore such policy language.

Second, clear and unambiguous disclaimers of any undertaking, warning against any unmerited reliance on the inspection, should be included in all inspection reports, whether or not the reports are intended to be shared with the insured or third parties. Whether intended to be shared outside the company or not, such documents have a way of getting around.

Third, on no account should policy forms, manuals, procedures, correspondence, or personnel refer to any kind of inspection as a "safety inspection." A neutral term, shorn of safety-related connotations (*e.g.*, "underwriting inspection"), should be used.

Fourth, insurers should have in their engineering, adjustment, and underwriting manuals and training materials a clear explanation of the self-serving nature of inspections, and how any incidental benefit to the insured or others is a collateral by-product of the insurer's underwriting and loss prevention goals. Having clear statements of the company's position in print *before* a claim arises is far more persuasive to a court and jury than self-serving affidavits and testimony prepared after the fact for purposes of litigation.

Fifth, underwriting, claims, engineering, inspection, adjustment, and marketing personnel should become familiar with the company's official position on the nature and purpose of inspections, so they do not inadvertently speak or act inconsistently with it.

Sixth, marketing pieces, coverage proposals, and advertisements should avoid explicitly

"pushing" the insurer's inspection, risk management, loss control, or loss prevention functions as a service to policyholders. Ideally, such matters should not be mentioned at all in connection with marketing efforts, but that ideal is probably unattainable in a competitive industry, in which many companies trade on the reputations of their inspection and loss prevention services.

Seventh, insurers should define and limit the scope of their inspections, and ensure policyholders are on notice of the limitations. Inspections should be related to hazards insured against, and not to any and all perils or threats to human safety. Needlessly broad inspections, beyond the insurer's underwriting and loss prevention needs, may suggest a § 324A undertaking.

Eighth, the costs of inspections should be subsumed within the insurer's overhead, and not appear as an itemized charge to the insured. Charging the insured an extra or separate fee for inspection services makes it much more likely that a § 324A undertaking will be found.

Ninth, in the event of litigation, defense counsel should try to enlist the cooperation and support of the insured. That includes trying to establish a united, cooperative defense with the insured if it is a party to the action. The insured's evidence can be crucial to the insurer's defense; either helping the insurer get out of the case on summary judgment, or making the insurer the target defendant and torpedoing it at trial.

Tenth, in the event of litigation, make every reasonable effort to dispose of the case by pre-trial motion practice. The reported cases strongly suggest what any experienced lawyer would suspect: juries are just as hostile to insurers in negligent inspection cases as in any other kind of case, and do not readily accept explanations of why particular hazards were not detected in underwriting inspections.

Eleventh, lawyers representing insurers should carefully parse the decisional law and distinguish adverse cases involving kinds of coverage different from that provided by their client. That is, a first-party property or general liability insurer should argue vigorously that adverse decisions involving boiler and machinery or workers' compensation coverages are not applicable to it.

Twelfth, practitioners should check for relevant enactments in the applicable statutory law. A number of states have statutes partially immunizing workers' compensation insurers from liability for alleged negligent inspections. Some of the statutes apply to all types of insurers.