

# 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 often exercise substantial creativity, requiring insurers and defense counsel to respond to theories of liability that challenge common assumptions in the insurance industry. Some courts, wishing to do what they perceive as "substantial justice," eagerly embrace such theories. One example of plaintiffs' creativity is their recurrent — and often successful — efforts to impose liability on insurers for allegedly negligent underwriting and loss prevention inspections. Such efforts are made where a plaintiff injured in the course of his employment wants to receive 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: *e.g.*, the owner and operator of a vehicle, the manufacturer of an allegedly defective and unreasonably dangerous machine, the engineer who designed dangerous premises, the owner or general contractor supervising a construction site, *etc.*

But what if the would-be plaintiff cannot identify a viable defendant to sue, either because there is no potential tortfeasor other than the employer, or because all obvious candidates for the role of defendant 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 that the insurer(s) performed one or more 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 extends beyond the limits of the insured employer's policy. Although the insurance industry regards such inspections as conducted purely in aid of insurers' underwriting and loss prevention efforts, and not for the benefit of either the insured or third parties, such claims have nevertheless generated 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, yet a number of lessons emerge. Those lessons should be borne in mind by insurers wishing to insulate themselves from this kind of action to the extent possible. This note samples recent case law in this area, reviews theories and factors commonly considered by courts in analyzing such claims by third parties, and offers some lessons for insurers confronted with such claims.

### ***General Factual Background***

As a routine part of their underwriting and loss control activities, many commercial property and casualty insurers conduct more or less systematic inspections of 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 — 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.

Once such an inspection has been performed, the inspector typically prepares for the insurer a written report of findings, often including recommendations for how the policyholder 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 upon the inspector's recommendations. In some instances, the issuance or renewal of a policy may be made contingent on the insured's compliance with some or all of the recommendations, which are then referred to by the oxymoron "*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 to evaluate the types and degrees of hazards for which his company could be liable under the terms and conditions of its policy, (b) helping to formulate recommendations that, if accepted and acted on 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 plant or personnel *per se*: if an underwriting or loss prevention inspection results in improved safety

practices that is fine, but it is merely an incidental by-product of the inspection's actual aim of improving the profitability of the insurer's business.<sup>1</sup>

Such inspections are essentially self-serving, performed for insurers' own benefit and not for the benefit of either policyholders or third parties (although benefitting policyholders and third parties is an unavoidable, incidental by-product of the process). In recognition of the self-serving nature of such inspections, many policies (particularly property and workers' compensation 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.<sup>2</sup>

Even if the insurance contract is silent as to inspections, inspection reports and recommendations sent to insureds often contain disclaimers, such as one of 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.<sup>3</sup>

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<sup>1</sup> See generally, J.J. LAUNIE, J.F. LEE, & N.A. BAGLINI, *PRINCIPLES OF PROPERTY AND LIABILITY UNDERWRITING* 52 (2d ed. 1977); E.P. HOLLINGSWORTH, JR., & J.J. LAUNIE, *COMMERCIAL PROPERTY AND MULTIPLE-LINES UNDERWRITING* 158, 505 (1st ed. 1978); L.D. GAUNT & N.A. WILLIAMS, *COMMERCIAL LIABILITY UNDERWRITING* 347 (1st ed. 1978).

<sup>2</sup> See, e.g., *Leroy v. Hartford Steam Boiler Inspection and Ins. Co.*, 695 F.Supp. 1120 (D.Kan. 1988); *Rosenhack v. State*, 112 Misc.2d 967, 447 N.Y.S.2d 856, 859 (Ct.Cl. 1982); *Brooks v. New Jersey Manufacturers Ins. Co.*, 170 N.J.Super. 20, 25, 405 A.2d 466, 468 (1979); *Riverbay Corp. v. Allendale Mut. Ins. Co.*, 1988 WL 52783 (S.D.N.Y. 1988); *Kent v. Jomac Products, Inc.*, 542 So.2d 99 (La.App. 1989).

<sup>3</sup> See *Smith v. Allendale Mut. Ins. Co.*, 410 Mich. 685, 303 N.W.2d 702, 714-715 (1981).

This report is intended to assist you in reducing the possibility of loss to the property insured with [the insurer] by bringing to your attention hazards and lack of protection which need prompt consideration to prevent such loss to property. It is not intended to imply that all other hazards and conditions are under control at the time of this inspection. The liability of [the insurer] is limited to that covered by [its] insurance policies. No other liability is assumed by reason of this report as it is only advisory in nature and the final decisions must be made by you.<sup>4</sup>

### ***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 generally is no such duty.<sup>5</sup> Plaintiffs also typically do not claim that the pertinent insurance contracts create or impose 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*, has assumed a duty to the policyholder, the policyholder's employees, and even members of the general public lawfully on the subject premises or using the subject equipment.<sup>6</sup> The nature of that claimed duty is to exercise reasonable care in making inspections, *including the duty to identify*

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<sup>4</sup> See *Riverbay Corp. v. Allendale Mut. Ins. Co.*, *supra*.

<sup>5</sup> *Smith v. Allendale Mut. Ins. Co.*, *supra*; *James v. State*, 90 A.D.2d 342, 457 N.Y.S.2d 148 (4th Dept. 1982), *aff'd*, 60 N.Y.2d 737, 469 N.Y.S.2d 695, 457 N.E.2d 802 (1983).

<sup>6</sup> See *Brown v. Michigan Millers Mut. Ins. Co., Inc.*, 665 S.W.2d 630 (Mo.App. 1983) (plaintiffs present on insured premises as employees of independent contractor); *Deines v. Vermeer Mfg. Co.*, 752 F.Supp. 989 (D.Kan.1990) (plaintiff was ultimate user of machine manufactured by defendant's insured); *Obenauer v. Liberty Mut. Ins. Co.*, 908 F.2d 316 (8th Cir. 1990) (plaintiff was operator of machine manufactured by defendant's insured).

*and bring to the insured's attention — and perhaps to the attention of others — all reasonably identifiable conditions that pose a risk of personal injury if not corrected.* Plaintiffs in such cases have infrequently — and unsuccessfully — attempted to frame their claims in terms of a breach of warranty or third-party beneficiary theory.<sup>7</sup>

Plaintiffs' theory is based on the oft-quoted statement by then Judge Cardozo that "one who assumes to act, even though gratuitously, may thereby become subject to the duty of acting carefully, if he acts at all."<sup>8</sup> Cardozo's *aperçu* and similar statements have been synthesized as § 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*.<sup>9</sup>

The principles embodied in § 324A are sometimes referred to as the "Good Samaritan" rule. A parallel section of the Restatement deals with the liability of the actor (here, the insurer) to one to whom he has undertaken to render services (here, the policyholder).<sup>10</sup>

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<sup>7</sup> *Mueller v. Daum & Dewey, Inc.*, 636 F.Supp. 192 (E.D.N.C. 1986).

<sup>8</sup> *Glanzer v. Shepard*, 233 N.Y. 236, 239, 135 N.E. 275, 276 (1922).

<sup>9</sup> RESTATEMENT (SECOND) OF TORTS [hereafter "RESTATEMENT"] § 324A (1965) (emphases added.)

<sup>10</sup> RESTATEMENT § 323 (1965).

Based on § 324A, 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) that peril thereafter actually occurred, and (d) as a result, the plaintiff was rendered sick, sore, lame, and disabled. If a court requires them to do so, plaintiffs will also allege, and attempt 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 the threshold requirement for applying § 324A: *that the defendant have undertaken to render services to another, which the defendant should recognize as necessary for the protection of a third party or his things.*<sup>11</sup> The requirement that there have been 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" is an actual assumption of responsibility to perform some service principally for the benefit of another.<sup>12</sup>

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<sup>11</sup> RESTATEMENT § 324A (1965); *Jansen v. Fidelity and Cas. Co. of New York*, 79 N.Y.2d 867, 581 N.Y.S.2d 156, 589 N.E.2d 379 (1992); *Smith v. Allendale Mut. Ins. Co.*, *supra*; *Deines v. Vermeer Mfg. Co.*, *supra*; *Leroy v. Hartford Steam Boiler Inspection and Ins. Co.*, *supra*, 695 F.Supp. at 1126; *Blalock v. Syracuse Stamping Co., Inc.*, 584 F.Supp. 454, 456 (E.D.Pa.1984).

<sup>12</sup> *Smith v. Allendale Mut. Ins. Co.*, *supra*, 303 N.W.2d 702, 710-712. *Accord*, *Jansen v. Fidelity and Cas. Co. of New York*, *supra*, 581 N.Y.S.2d at 157 ("The application of this principle has been limited to 'those situations wherein the action taken is for the benefit of another and not in furtherance of the interest of the one who assumes to act.'")

The insurer's classic position is therefore that its inspection of the insured's premises or operations was conducted purely for the insurer's own benefit, as a routine part of its underwriting and loss prevention practices, and did not constitute an "undertak[ing] to render services to another" within the contemplation of § 324A of the Restatement. In support of that contention, insurers point to (a) the industry's customary understanding of such inspections, (b) the insurer's own internal understanding of and intent behind the inspection, (c) the insurer's policy language, expressly denying any undertaking, and (d) the insurer's disclaimers on its inspection reports. Those arguments have been successful in many cases.<sup>13</sup>

Some courts, however, effectively eliminate the undertaking requirement from § 324A, either by ignoring it,<sup>14</sup> or by holding that inspections with the dual effects of helping the insurer with its 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 the inspection does not remove the inspection from the scope of § 324A.<sup>15</sup> In other cases, courts engage in fact-sensitive inquiries to see whether there is evidence of an undertaking.

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<sup>13</sup> E.g., *Jansen v. Fidelity & Cas. Co. of New York*, *supra*; *Smith v. Allendale Mut. Ins. Co.*, *supra*; *Riverbay Corp. v. Allendale Mut. Ins. Co.*, *supra*; *Leroy v. Hartford Steam Boiler Inspection and Ins. Co.*, *supra*; *Mueller v. Daum & Dewey, Inc.*, *supra*; cf. *Graham v. Milky Way Barge, Inc.*, 923 F.2d 1100 (5th Cir. 1991) (inspection by broker); *Obenauer v. Liberty Mut. Ins. Co.*, *supra* (Montana law); *Kent v. Jomac Products, Inc.*, *supra*; *Kennard v. Liberty Mut. Ins. Co.*, 277 So.2d 170, 174 (La.App., 1972).

<sup>14</sup> E.g., *Huggins v. Aetna Cas. & Sur. Co.*, 245 Ga. 248, 264 S.E.2d 191 (1980); *Phillips v. Liberty Mut. Ins. Co.*, 813 F.2d 1173 (11th Cir. 1987) (Georgia law).

<sup>15</sup> *Deines*, *supra*, 752 F.Supp. at 994 (policy language negating undertaking is void as against public policy); *Brown v. Michigan Millers Mut. Ins. Co., Inc.*, *supra*; *Cleveland v. American Motorists Ins. Co.*, 163 Ga.App. 748, 295 S.E.2d 190 (Ga.App. 1982) (insurer may not "summarily extract itself from the realm of negligent inspection actions \* \* \* merely by inserting into the insurance contract a clause stating that the inspections are being undertaken solely for risk management or other internal purposes"); *Nelson v. Union Wire Rope Corp.*, 31 Ill.2d 69, 199 N.E.2d 769 (1964) (analyzing issue in terms of

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## ***Evidence of an Undertaking***

Although Cardozo did say that "one who assumes to act, even though gratuitously, *may* thereby become subject to the duty of acting carefully, if he acts at all,"<sup>16</sup> that is not *all* he said, and the specific factual setting that confronted him in *Glanzer v. Shepard* was a far cry from that in the typical negligent inspection case. Glanzer bought a shipment of 905 bags of beans from a supplier. The beans were to be paid for by weight, in accordance with weight sheets to be certified by public weighers. The public weighers, specifically retained by the seller for the purpose of this transaction, weighed the beans at pierside and certified their weight to be 228,380 pounds. The weighers gave both Glanzer and the seller copies of the certified weight sheets, and Glanzer duly paid for the beans in accordance with those weight sheets. It turned out the weighers weighed the beans negligently, and their actual weight was 11,854 pounds less than the weighers certified. Glanzer sued the weighers, whose defense was that they had not been retained by Glanzer, had no contract with Glanzer, and therefore owed no duty of due care to Glanzer.

The New York Court of Appeals rejected the weighers' position, analyzing the case not in terms of privity of contract, but in terms of the assumption of a duty. The weighers knew the purpose of their retention and that their weighing was to be relied on by both the buyer and seller of the beans. The buyer's use of the weight certificates "was not an indirect or collateral consequence of the action of the weighers. It was a consequence which, to the weighers' knowledge, was the end

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foreseeability, because evidence "fully negates any concept that \* \* \* inspections were *solely* for its own internal purposes;" emphasis added).

and aim of the transaction,"<sup>17</sup> and the weighers were deemed to have undertaken to perform a service for the use and benefit of both buyer and seller. The weighers owed a duty of due care to both buyer and seller, even though only the seller formally retained and paid them.

The typical insurance underwriting or loss control inspection, on the other hand, is performed for the use and benefit of the insurer. The "end and aim of the transaction" is to give the insurer knowledge that will be useful to it in underwriting profitable business, not to benefit the insured or its employees. Any benefit thereby conferred on the insured or its employees usually is *precisely* "an indirect or collateral consequence" of the inspection. In contesting the element of an undertaking, the insurer's defense should accentuate those differences.

Cardozo himself recognized the limitations of his statement in *Glanzer v. Shepard, id.* In a later case,<sup>18</sup> then Chief Judge Cardozo explained how to determine when one who has assumed to act might thereby become subject to a duty to act carefully:

If conduct has gone forward to such a stage that inaction would commonly result, not negatively merely in withholding a benefit, but positively or actively in working an injury, there exists a relation out of which arises a duty to go forward. \* \* \* The query is always whether the putative wrongdoer has advanced to such a point as to have launched a force or instrument of harm, or has stopped where inaction is at most a refusal to become an instrument for good.<sup>19</sup>

It is the rare negligent inspection case in which that query would be answered affirmatively.

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<sup>16</sup> *Glanzer v. Shepard, supra*, 233 N.Y. at 239, 135 N.E. at 276 (emphasis added).

<sup>17</sup> *Id.*, 233 N.Y. at 238-239, 135 N.E. at 275.

<sup>18</sup> *H.R. Moch, Inc. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928).

<sup>19</sup> *Id.*, 247 N.Y. at 167, 159 N.E. at 898.

Plaintiffs in negligent inspection cases, ignoring those of Cardozo's views uncongenial to their claims, often urge that the mere act of inspecting, by itself, betokens an undertaking within the meaning of § 324A. Insurers tend to do best in negligent inspection cases when they keep the court's attention firmly focused on the essence of the insurance relationship and the insurer's self-serving purposes in conducting inspections, as expressed and limited by the language of the insurance policy itself. Once again, the decision of the Michigan Supreme Court in *Smith v. Allendale Mut. Ins. Co.*, *supra*, provides a strong, clear statement of the insurer's position on what kind of factual showing should be necessary before a § 324A undertaking is found:

\* \* \* It is not enough that the insurer acted. It must have undertaken to render services to another. Its acts do not constitute such an undertaking unless it agreed or intended to benefit the insured or its employees by the inspections.

\* \* \* While an undertaking which may give rise to liability under the rule of § 324A may be gratuitous as well as contractual, the evidence must show that the actor assumed an obligation or intended to render services for the benefit of another. Evidence demonstrating merely that a benefit was conferred upon another is not sufficient to establish an undertaking which betokens duty. Persons pursuing their own interests often benefit others in the process. Accordingly, where a plaintiff seeks to prove an undertaking by conduct which benefits another and that conduct is consistent with a primary purpose on the part of the actor to benefit himself, the plaintiff must offer additional evidence to create a jury question whether there was an undertaking to render services and hence a duty to one who might foreseeably be injured by the actor's failure to perform the undertaking with reasonable care.

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This is not to say that a fire insurer may not undertake to render fire inspection services to its insured and thereby incur a duty, breach of which will subject it to liability. If the insurer promises to provide complete fire inspection services to alert the insured to fire hazards on the premises, its failure to exercise reasonable care in performing that undertaking will subject it to liability under the rule of § 324A. \* \* \* [I]f the insurer's advertising or communications with its policyholders represent that its inspection services will relieve the insured of the burden of monitoring its own facilities, it has undertaken to render inspection services for the benefit of the insured

and is subject to liability if it fails to exercise reasonable care in performing that undertaking.<sup>20</sup>

### ***The Insurer's Advertising***

Those courts that do not read the undertaking requirement right out of § 324A usually conduct factual inquiries to see if there is evidence of a specific intent to benefit the insured or third parties, rather than to fulfill primarily the self-serving purposes of the insurer. Such courts often do not have to look very hard for such evidence, since it is often plentiful in the insurer's advertisements, marketing pieces, and coverage proposals.<sup>21</sup>

The court's *dictum* in *Smith v. Allendale Mut. Ins. Co.*, that an insurer's advertising might be evidence of an undertaking in an appropriate case, has been followed — sometimes with a vengeance — in a number of cases.<sup>22</sup> Nevertheless, some courts have held that explicit policy language permitting, but not obligating, the insurer to make inspections for its own benefit controls over any marketing documents that might suggest another purpose.<sup>23</sup>

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<sup>20</sup> *Smith, supra*, 303 N.W.2d at 710-712 (footnotes omitted).

<sup>21</sup> See, e.g., *Derosia v. Liberty Mut. Ins. Co.*, 155 Vt. 178, 583 A.2d 881 (1990); *Pratt v. Liberty Mut. Ins. Co.*, 952 F.2d 667 (2d Cir. 1992) (Vt. law); *Deines v. Vermeer Mfg. Co., supra*; *Brown v. Michigan Millers Mut. Ins. Co., Inc., supra*; *Nelson v. Union Wire Rope Corp., supra*.

<sup>22</sup> E.g., *Deines v. Vermeer Mfg. Co., supra*; *Brown v. Michigan Millers Mut. Ins. Co., Inc., supra* (insurer's advertisements and original coverage proposal to insured implied benefits to insured from insurer's inspection services, but did not state or imply that "its inspection services will relieve the insured of the burden of monitoring its own facilities").

<sup>23</sup> *James v. State, supra*, 90 A.D.2d at 345, 457 N.Y.S.2d at 151. Accord, *Riverbay Corp., supra* (insurer's advertising brochure touted effectiveness of loss prevention and control services, including inspections, as part of single package combining risk management and insurance coverage).

### ***The Scope of the Inspection***

If the insurer's inspections can be characterized as more comprehensive, more frequent, or more detailed than needed for its own benefit, plaintiffs will argue that that is evidence of an intent to benefit the insured or third parties; *i.e.*, evidence of a § 324A undertaking.<sup>24</sup> Alternatively, the plaintiff might use the same evidence to argue that the inspections were designed 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, making out a claim under § 324A(b). 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 claims.<sup>25</sup>

Even the *name* by which an insurer refers to its inspections may be seized upon by some courts as evidence of a purpose to benefit an insured or third parties.<sup>26</sup>

### ***The Type of Insurance Provided***

The outcome of a negligent inspection case often turns on the type of coverage for which the inspection was made. Most courts draw sharp — and appropriate — distinctions between third-

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<sup>24</sup> *E.g.*, *Riverbay Corp.*, *supra* (inspection of objects not covered by boiler & machinery policy); *Smith v. Allendale Mut. Ins. Co.*, *supra*, 303 N.W.2d at 713; *Blalock v. Syracuse Stamping Co., Inc.*, *supra*, 584 F.Supp. at 457 (breadth of inspection may raise issue of fact as to existence of duty).

<sup>25</sup> *See, e.g.*, *Blalock v. Syracuse Stamping Co., Inc.*, *supra*, 584 F.Supp. at 457. *But cf.* *Van Winkle v. American Steam Boiler (Insurance) Co.*, 52 N.J.L. 240, 23 Vroom 240, 19 A. 472 (1890) (court relies on, *inter alia*, narrowness of inspection — of a single boiler — as ground for finding undertaking).

<sup>26</sup> *Deines, supra*, 752 F.Supp. at 994, n. 3 (insurer referred to inspections as *safety inspections*: "Safety inspections, by their very nature, involve considerations of the well-being and protection of third parties.")

party liability, workers' compensation, and first-party property insurance in analyzing the insurer's responsibility for its 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 insurers to be treated somewhat more harshly than, say, first-party property insurers (but worker's compensation insurers benefit from statutory immunity in some states, *see infra*.) That is because workers' compensation carriers' inspections are intended to and do actually focus on personnel safety issues, whereas property insurers typically inspect only for conditions that threaten losses to property (boiler and machinery coverage presents its own special problems; *see infra*). Property insurers are therefore better able than workers' compensation carriers to argue that they never "undertook" to inspect for personal safety risks. Courts may also be operating under a tacit notion that, after all, workers' compensation carriers have charged a premium for accepting *some* risk of personal injuries, whereas first party property insurers generally have not. Even that bulwark of the insurers' defense, *Smith v. Allendale Mut. Ins. Co.*, *supra*, explicitly distinguishes between workers' compensation and boiler and machinery coverages, on the one hand, and first-party fire insurance, on the other.<sup>27</sup>

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*Smith v. Allendale Mut. Ins. Co.*, 303 N.W.2d 702, 719.

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

What if the insurer performs regular inspections of one or more specific, highly dangerous instrumentalities, and also provides the insured with a certificate attesting to the fitness of those instrumentalities? What if, in addition, that certificate discharges the insured's statutory obligation to inspect those instrumentalities, 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, direct a shut-down of the dangerous instrumentality if he finds an unacceptable condition? Such facts sound much closer to those of *Glanzer v. Shepard, supra*, than does a routine underwriting inspection, making it likelier that a court will find a § 324A undertaking. That is the special situation presented by negligent inspection 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 their principal reason for buying boiler and machinery coverage.<sup>28</sup> Under such circumstances, negligent inspection cases arising under boiler and machinery policies often present substantial evidence of an actual undertaking, resulting in judicial decisions adverse to insurers.<sup>29</sup>

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M.S. RHODES, *THE LAW OF COMMERCIAL INSURANCE* 239 (1st ed. 1992).

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*E.g., Leroy v. Hartford Steam Boiler Inspection and Ins. Co., supra* (distinctions drawn between workers' compensation, general liability, and boiler and machinery insurers); *Seay v. Travelers Indemnity Co.*, 730 S.W.2d 774 © Thomas M. Bower 1994

### ***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, *supra*, in other jurisdictions they have been largely immunized from such claims, by either judicial decision or legislative action.<sup>30</sup> Some states have enacted statutes that partially immunize all insurers, not just workers' compensation carriers, from negligent inspection claims.<sup>31</sup>

### ***Other Elements of § 324A***

An undertaking by itself is not enough to create liability. The facts must also support a finding that at least one of the additional three circumstances listed in Restatement § 324A is 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

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(Tex.App. 1987); *Van Winkle v. American Steam Boiler (Insurance) Co.*, *supra*. But see *Riverbay Corp.*, *supra* (boiler inspection held, on basis of policy language, not to be an undertaking).

<sup>30</sup> E.g., *Kifer v. Liberty Mut. Ins. Co.*, 777 F.2d 1325 (8th Cir. 1985); *Leroy v. Hartford Steam Boiler Inspection and Ins. Co.*, *supra* (drawing distinctions between workers' compensation and other types of insurance); *UNR Industries, Inc. v. American Mut. Liability Ins. Co.*, 92 B.R. 319 (N.D.Ill. 1988) (workers' compensation carrier immune from claims for indemnity or contribution by third party liable in tort to insured's injured employees); *Malkiewicz v. R.R. Donnelley & Sons Co.*, 703 F.Supp. 49 (M.D.Tenn. 1989), *aff'd*, 932 F.2d 968 (6th Cir. 1991) (guarantor of self-insured employer entitled to same immunity as workers' compensation insurer under Tennessee law); *Smith v. Allendale Mut. Ins. Co.*, *supra*, 303 N.W.2d at 718, nn. 45 & 46 (collecting pertinent cases and statutes).

<sup>31</sup> See *A.O. Smith Corp. v. Protection Mut. Ins. Co.*, 79 F.R.D. 91 (E.D.Wis. 1978).

(c) the harm must have been suffered because of reliance of the insured or of the injured third party upon the insurer's undertaking.<sup>32</sup>

### ***Increasing the Risk of Harm***

Although many decisions acknowledge in the abstract that an insurer may be liable if its inspection increases the risk of harm, few plaintiffs actually make such a claim. The Reporter's Notes to § 324A gives the following illustration of what is meant by this idea:

A operates a grocery store. An electric light hanging over one of the aisles of the store becomes defective, and A calls B Electric Company to repair it. B Company sends a workman, who repairs the light, but leaves the fixture so insecurely attached that it falls upon and injures C, a customer in the store who is walking down the aisle. B Company is subject to liability to C.<sup>33</sup>

The Restatement therefore contemplates a situation in which the actor has done more than merely fail to detect a pre-existing hazard: there must be conduct that actually and affirmatively increases the risk of harm. Negligent inspection cases in which an insurer's inspector actually increases the risk of harm will be few and far between, and will most likely involve an insured's acceptance of an inspector's recommendation that turns out to cause harm to third parties.

However, one court has purported to find, with no illuminating discussion or analysis, 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.<sup>34</sup> Insurers confronting such allegations should argue that

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<sup>32</sup> RESTATEMENT § 324A (1965).

<sup>33</sup> *Id.*, Reporter's Notes § 324A, comment *c* at 143 (1965).

<sup>34</sup> *Brown v. Michigan Millers Mut. Ins. Co.*, *supra*, 665 S.W.2d at 636.

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.

***Performing a Duty Owed by  
the Insured to a Third Party***

Many negligent insurance claims proceed under the rule of § 324A(b), on a claim that an insurer undertook an insured's duty to provide safe premises, a safe workplace, or a safe product.<sup>35</sup>

That theory raises an interesting question, briefly discussed, but not decided, in *Smith v. Allendale Mut. Ins. Co.*, *supra*:

[I]t is by no means clear that liability can be founded upon subparagraph (b) where the duty alleged to have been assumed, the duty to provide a safe workplace, could not have been enforced in tort against the person whose duty it is claimed was assumed. \* \* \* Here, the employer's common-law duty to provide its employees with a safe place to work has been rendered unenforceable in tort by a workers' compensation statute, which limits the employer's liability to its employees to statutory benefits regardless of the care or indifference shown for employee safety.<sup>36</sup>

The *Smith* court did not have to decide that issue, but noted that its resolution might lie in the distinction between *duty* and *remedy*. Arguably, most workers' compensation statutes affect only the form of *remedy* available to an employee injured on the job, not the existence of an employer's legal *duty* to provide a safe workplace. None of the other decisions cited in this article analyze the issue in any further detail, and it remains a potential arguing point.

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<sup>35</sup> *E.g., Deines v. Vermeer Manufacturing Co.*, *supra*.

<sup>36</sup> *Smith v. Allendale Mut. Ins. Co.*, *supra*, 303 N.W.2d at 715.

### *Reliance on the Undertaking*

Restatement § 324A(c) provides that liability may attach where "the harm is suffered because of reliance of the other or the third person upon the undertaking."<sup>37</sup> Comment *e* to § 324A says the reliance must be a cause in fact of the injury:

Where the reliance of the other, or of the third person, has induced him to forgo other remedies or precautions against such a risk, the harm results from the negligence as fully as if the actor had created the risk.<sup>38</sup>

Note that the element of reliance may be supplied by either the reliance of the "other" (*i.e.*, the insured) or of "the third person" (*i.e.*, the injured plaintiff). Reliance by either of them will suffice.<sup>39</sup>

The requirement of actual reliance was once a serious obstacle to plaintiffs in negligent inspection claims because they could seldom prove actual reliance, but that may no longer be the case.

In *Smith v. Allendale Mut. Ins. Co.*, *supra*, the Supreme Court of Michigan was presented with evidence that the inspector's recommendations were routinely communicated to the insured and that the insured sometimes acted upon them, but held that such evidence was insufficient to show the insured's actual reliance, since there was no showing the insured had foregone its own inspections or other precautions in reliance on the insurer's inspections. In addition, the plant modifications the plaintiff alleged the insurer should have recommended to the insured were so extensive that the court deemed it unlikely the insured would have made them if they had been recommended.<sup>40</sup>

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<sup>37</sup> RESTATEMENT § 324A(c) (1965).

<sup>38</sup> *Id.*, Reporter's Notes § 324A(c), comment *e* at 144 (1965).

<sup>39</sup> *Huggins v. Aetna Cas. & Sur. Co.*, *supra*.

<sup>40</sup> *Smith v. Allendale Mut. Ins. Co.*, *supra*, 303 N.W.2d at 715, n. 33. Accord, *Blalock v. Syracuse Stamping Co., Inc.*, *supra* (insured's testimony did not show reliance; "at most [it showed] that [insured] acknowledged [insurer's] greater  
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The treatment of the element of reliance in cases like *Smith* and *Blalock, supra*, is diametrically opposed to that in another line of cases<sup>41</sup> in which courts have shown a readiness to permit even vague, equivocal, circumstantial, and conclusory evidence of reliance to defeat an insurer's motion for summary judgment<sup>42</sup> or support a verdict against an insurer.<sup>43</sup> In *Smith v. Universal Underwriters Ins. Co., supra*, 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, makes out a sufficient case of reliance to raise a jury issue! Far from being an obstacle, the element of reliance is now seemingly a highway to recovery in some jurisdictions.

Insurers confronting a claim of reliance should leave no stone unturned in efforts to show that the alleged reliance was unfounded and unreasonable. The more unreasonable the better, for two reasons: first, to demonstrate to the trier of fact that the plaintiff's claim of reliance is incredible, because no one could entertain such an unreasonable reliance and, second, to try to lay a foundation for asking the court to hold as a matter of law that the alleged reliance was so objectively unreasonable that it was not the kind of reliance contemplated by § 324A(c). Note that

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expertise in fire protection and safety and \* \* \* sought to implement all reasonable recommendations made by [insurer] with which [insured] agreed).

<sup>41</sup> E.g., *Deines v. Vermeer Manufacturing Co., supra*; *Phillips v. Liberty Mut. Ins. Co., supra*; *Smith v. Universal Underwriters Ins. Co.*, 752 F.2d 1535 (11th Cir. 1985); and *Huggins v. Aetna Cas. & Sur. Co., supra*, reversing 151 Ga.App. 377, 259 S.E.2d 742 (1979).

<sup>42</sup> *Huggins, id.*

<sup>43</sup> *Phillips, supra.*

RESTATEMENT §324A(c) does not explicitly say the reliance must be reasonable. Insurers must therefore also argue that the requirement of *reasonable* reliance is implicit: why should liability be premised on a plaintiff's subjective, *unreasonable* reliance?

In this context, circumstantial evidence of the insured's actual expectations is important. Although the parties' expectations are normally less relevant in a tort than in a contract case, evidence of the expectations of the insured and its employees can shed light on whether there was either actual reliance or an undertaking, *i.e.*, an agreement or intention to benefit the insured or its employees by the inspection.<sup>44</sup> For example, if the insured conducted its own inspection program, or had inspections by others, that would tend to rebut a claim that the insurer's inspection was an undertaking relied on by the insured or others. Similarly, if the insured had a history of ignoring or arguing with the insurer's recommendations, that would also tend to rebut both an undertaking and reliance.

Insurers can create their own evidence of *non*-reliance by peppering the written record with statements to the clear 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 the results of inspections, as well as in general information distributed to policyholders. If there has been an exchange of such correspondence with the insured

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*Smith v. Allendale Mut. Ins. Co.*, *supra*, 303 N.W.2d 702, 711.

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 ordinary requirement that a plaintiff prove as an essential element of his *prima facie* case that his injury was proximately caused by the defendant. Therefore, insurers defending negligent inspection claims should strictly require plaintiffs to prove by a preponderance of the evidence that, if the insurer's inspection 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 necessarily case-specific, but there are a few areas the insured should look into as a matter of course. Does the applicable policy *require* the insured to correct any adverse condition identified by insurer or follow any of the insurer's recommendations, or was the policyholder free to ignore them? Has the insured in fact timely followed each and every one of the insurer's, or prior insurers', recommendations in the past? Was the particular dangerous condition at issue in the case already brought to the insured's attention by anyone other than the defendant insurer? Was the particular recommendation at issue in the case 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 have been aware of and in compliance with it absent any recommendation by the insurer?  
*Etc.*

### ***Public Policy Considerations***

Considerations of fairness and public policy provide strong reasons for not imposing liability on insurers in the absence of a clear § 324A undertaking. The reasons of fairness were well expressed almost thirty years ago by the dissent in *Nelson v. Union Wire Rope Corp.*:

\* \* \* 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.<sup>45</sup>

Furthermore, having too many decisions adverse to insurers in this area is bound either to discourage insurers from performing some insurance inspections (which would eventually result in inaccurate, and perhaps excessive, insurance pricing), or to lead insurers to institute much more costly inspection programs than necessary for their own purposes and to pass on those costs (plus the costs of judgments or E&O coverage, if available) to their insureds. Insurance premiums that should be based on overhead plus an actuarial assessment of the insured risk, would have to be substantially increased to provide for insurers' new public liability exposure.<sup>46</sup> A number of state legislatures share that concern: in many states whose courts initially held that injured employees could maintain

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<sup>45</sup> *Nelson v. Union Wire Rope Corp.*, *supra*, 39 Ill.2d at 119.

<sup>46</sup> *Smith v. Allendale Mut. Ins. Co.*, *supra*, 303 N.W.2d 702, 720-721.

negligent inspections actions against workers' compensation carriers the legislatures thereafter amended the workers' compensation statutes to preclude such actions.<sup>47</sup>

Finally, of course, the law should not unnecessarily discourage insurers from making limited inspections for underwriting and loss prevention purposes, because even a careless inspector detects and initiates cures for far more hazards than he misses: even a limited or negligent inspection is probably better than no inspection at all.

### ***Undecided Issue: How Far Does the Duty Extend?***

Assuming that a duty to inspect carefully exists in a particular case, what does that duty require an inspecting 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 undoubtedly incite litigation by the insured for defamation, business disparagement, bad faith, interference with contractual relations, and a variety of other claims, but one day a clever plaintiff's lawyer will allege that an insurer had 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.

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*See, e.g., Smith v. Allendale Mut. Ins. Co., supra*, 303 N.W.2d 702, 718, n. 46.

## ***Lessons to Be Learned***

The decisions in this area go off in a variety of conflicting directions. The applicable law changes markedly from jurisdiction to jurisdiction, making it impossible to reach broad definitive conclusions. Nevertheless, there are some common sense conclusions for insurers interested in minimizing their potential negligent inspection exposures. Some of the following suggestions might conflict with other goals — especially marketing goals — of particular insurers. Each company has to decide for itself how far it is willing to compromise other objectives to minimize its exposure to negligent inspection claims.

First and foremost, if an insurer's policy forms do not include specific language, clearly and unambiguously stating that any inspections 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 seem prepared to seize on almost any circumstance to justify ignoring 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 they are intended to be shared with anyone outside the insurer or not, such documents have a way of getting around. Once they get outside the insurance company, anyone can claim to have "relied" on them.

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

Fourth, insurers should put into their engineering, adjustment, and underwriting manuals and other 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 such clear statements of the company's official position in print *before* any liability occurrence will be more persuasive to a court and jury than any number of self-serving affidavits and testimony prepared for litigation after the fact.

Fifth, underwriting, claims, engineering, inspection, and adjustment personnel should be familiarized with the company's official position as regards the nature and purposes 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 is one ideal goal that is probably unattainable in a highly competitive industry.

Seventh, insurers should define and limit the scope of their inspections, and ensure that policyholders are aware of the limitations. Inspections should be related to hazards insured against, and not to any and all hazards or threats to human safety. Needlessly broad, wide-ranging 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 any 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 to get out of the case on summary judgment, or making the insurer the target defendant and sinking it at trial. In *Mueller v. Daum & Dewey, Inc.*, for example, employees of the insured supported the insurer by testifying that the insurer did not undertake to conduct safety inspections of the insured's plant, and that the insured did not rely on the insurer's inspections as proof that the plant was safe.<sup>48</sup> In *Seay v. Travelers Indemnity Co.*, the policyholder's chief administrative officer torpedoed the insurer's defense by supplying the plaintiff with an affidavit

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*Mueller v. Daum & Dewey, Inc.*, *supra*, 636 F.Supp. at 195.

stating that he had relied on the insurer's boiler inspections and would have complied with any recommendation the insurer made regarding any risk to the policyholder's personnel.<sup>49</sup>

Tenth, make every reasonable effort to dispose of the case on a pre-trial motion for summary judgment or the equivalent. Review of the reported cases strongly suggests what any experienced practitioner 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 insurers' explanations of why particular hazards were not detected by underwriting inspections.

Eleventh, practitioners representing insurers should carefully parse the decisional law and distinguish adverse cases involving kinds of insurance coverage different from that provided by their clients. That is, a first-party property or general liability insurer should argue vigorously, *à la Smith v. Allendale Mut. Ins. Co.*, that adverse decisions involving boiler and machinery or workers' compensation carriers are not applicable to it.

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

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*Seay v. Travelers Indemnity Co.*, *supra*, 730 S.W.2d at 780.