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THE EROSION OF THE DIRECT ACTION RULE IN INDIANA

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Indiana courts have long recognized that an injured party may not bring suit for damages directly against the alleged wrongdoer's liability insurer. This rule of law is often referred to as the "direct action rule."[1] The purpose of the rule arguably revolves around the alleged wrongdoer's fiduciary relationship with its insurer.[2] That relationship is created by the insured's payment of insurance premiums to the insurer, thereby creating a contractual relationship and a duty to defend and indemnify the insured on the part of the insurer. The insurer also owes the insured a duty of good faith and fair dealing.[3] Of course, the insured also has duties to the insurer, including compliance with policy provisions.[4] Indiana courts consistently have held that injured third parties are not permitted to bring direct actions against insurers because the third parties are not parties to the insurance contract; they thus lack standing to bring suit directly against the insurer.[5]

However, some recent decisions have chipped away at Indiana's long-standing adherence to the direct action rule and have provided exceptions to its strict application. These recent decisions provide third parties with powerful tools to help ascertain their rights and protect their right to a remedy. At the same time, these recent decisions challenge the principles that form the bases for applica-

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[1] The rule of law that an injured party may not bring suit directly against the alleged wrongdoer's liability insurer will be referred to throughout this article as the "direct action rule." An excellent article regarding Indiana cases abrogating the direct action rule was written by J. Richard Moore in 2001, for which he won the Harrison Legal Writing Award. *See* J. Richard Moore, *The Doomed Direct Action Rule*, 44 Res Gestae 28 (2001). This article addresses much of the same subject matter.

[2] *See* Bennett v. Slater, 289 N.E.2d 144, 148 (Ind. Ct. App. 1972).

[3] *See* Erie Ins. Co. v. Hickman, 622 N.E.2d 515, 518 (Ind. 1993); Gooch v. State Farm Mut. Auto. Ins. Co., 712 N.E.2d 38 (Ind. Ct. App. 1999).

[4] *See* Paint Shuttle, Inc. v. Continental Cas. Co., 733 N.E.2d 513, 521 (Ind. Ct. App. 2000).

[5] To be a real party in interest, one must have a present or substantial interest in the relief sought and be entitled to the fruits of the action. Town of Munster v. Hluska, 646 N.E.2d 1009, 1014 (Ind. Ct. App. 1995) (citing Brenner v. Powers, 584 N.E.2d 569, 574 (Ind. Ct. App. 1992)); Estate of Ryan v. Great-West Life Assur. Co., 517 N.E.2d 109, 110 (Ind. Ct. App. 1987).

tion of the direct action rule and present some interesting questions with regard to the rule's applicability in particular circumstances that have yet to be addressed by Indiana's courts. Further, they call into question the future of the direct action rule in Indiana.

I. History of the Direct Action Rule in Indiana

A. *Martin v. Lilly* and *Martin v. Levinson*

The Indiana Supreme Court recognized the direct action rule as long ago as 1919, in *Martin v. Lilly*.[6] In that case, Martha Lilly was injured while riding on the rear seat of a motorcycle when it was struck by an automobile owned by Richard Martin and operated by Joseph Schofield.[7] At trial, Lilly obtained a verdict and judgment in her favor. On appeal, error was claimed to have been committed by Lilly's counsel in asking about and discussing indemnity insurance in voir dire and on direct examination. The court found the attorney's conduct to be in error and remanded the case for a new trial stating, "Defendants are not to be punished for having insurance. Under our law, the insurance company is not a party."[8] This was still the rule in Indiana more than sixty years later. In *Martin v. Levinson,*[9] decided in 1980, the Indiana Court of Appeals stated, "It is also clear that under Indiana law a suit based on a contract theory directly against a liability insurer by an injured third party is inappropriate."

B. *Bennett v. Slater*

Other Indiana courts have expounded the general holding that an injured party may not bring suit directly against the alleged wrongdoer's liability insurer. In *Bennett v. Slater*,[10] Alice Bennett brought suit against Raymond Slater for personal injuries she sustained in an automobile accident. She obtained a judgment from the trial court. The judgment amount was double Slater's insurance policy limit, and the insurer paid Bennett the policy limits in satisfaction of the judgment. Bennett then brought suit against the insurer alleging that the insurer made a settlement offer to Bennett prior to the trial and that in response Bennett had offered to settle her claim for the policy limit. The insurer refused to settle the case and allowed the case to proceed to trial, at which the verdict in an amount double the policy limit was rendered.

Bennett's suit against the insurer alleged that the insurer negligently handled the claim by failing to make a reasonable effort to settle the claim when the insurer should have known there was a risk of recovery beyond the policy limit. In addition, the complaint alleged that the insurer should have taken the poten-

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6 121 N.E. 443 (Ind. 1919).

7 James Schofield, the driver, was accompanied by Mr. Martin's minor son (also named Richard Martin). *Id.* at 444.

8 *Id.* at 445.

9 409 N.E.2d 1239, 1243 (Ind. Ct. App. 1980).

10 289 N.E.2d 144 (Ind. Ct. App. 1972).

tial risk into consideration in the interest of its duty to its insured, Slater. Slater refused to be made a party-plaintiff to the action and service was never obtained upon him. However, Bennett joined Slater as a party-defendant to the action under Indiana Rule of Trial Procedure 20(A).

The insurer filed a motion to dismiss for failure to state a claim, which the trial court sustained. Bennett then filed a motion to correct errors, which the trial court overruled. On appeal, the court acknowledged the issue to be determined as "whether an injured party . . . would have standing to directly sue the insurer for its negligence where the insured refuses himself to sue."[11] Bennett attempted to make herself a third-party beneficiary to the possible tort action available to Slater against his insurer for negligently handling the claim. The court found that the insurer owed no duty to Bennett. The court also rejected Bennett's argument that she was entitled to recover on subrogation grounds with Slater as the creditor. The court found that allowing Bennett to proceed on such a theory would negate any further right of the insured, an unfair result in his absence; thus Bennett had no standing to bring an action against the insurer for failure to settle the claim.

C. *WINCHELL V. AETNA LIFE & CASUALTY INSURANCE CO.*

A variation of the court's holding in the *Bennett* case was reached in *Winchell v. Aetna Life & Casualty Insurance Co.*[12] That case was very similar to *Bennett*, except that the plaintiff and defendant were insured by the same company, and the defendant had not yet indicated whether it would sue its insurer. The plaintiff argued that her relationship with the insurance company created a fiduciary relationship between her and the insurer with regard to the plaintiff's claim against the defendant.

The court found the plaintiff could not use her relationship as a policyholder to "bootstrap" into a better position in the lawsuit because the fiduciary relationship between insurer and insured did not extend to the lawsuit filed by the insured against another person insured by the same insurance company. Further, the court found the litigation to be premature because the defendant in the trial court had not indicated whether he would bring suit against his insurer for negligent handling of the claim. The court stated that the particular case facts gave the prior decision in *Bennett* even greater weight: "If a party with a claim against the insured cannot maintain an action against the insurer even when the insured refuses to sue, then surely the claimant cannot maintain such an action before the insured indicates that it will not sue its insurer."[13]

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11 *Id.* at 146. The insured party, Slater, made no assignment of any claim he might have against the insurer for failure to settle.

12 394 N.E.2d 1114 (Ind. Ct. App. 1979).

13 *Id.* at 1117.

D. *RAUSCH V. REINHOLD* AND *MENEFEE V. SCHURR*

The direct action rule was once again reaffirmed by the Indiana Court of Appeals in *Rausch v. Reinhold*.[14] In that case, a truck driver injured by an auger brought suit against the driver of the auger and the driver's insurer. The trial court entered summary judgment in favor of the insurer. On appeal, Reinhold asked the court to abandon its "well-established [direct action] rule"[15] and allow him to sue the insurer solely because of the insurer's relationship to its insured. The court upheld the direct action rule, stating that "any change in this area of the law must come from the legislature or the supreme court."[16]

A similar decision was reached in *Menefee v. Schurr*.[17] That case combined three separate actions whereby motorists who had been injured in automobile accidents brought suit against drivers of the other vehicles involved and also asserted claims directly against the other drivers' insurers for bad faith in handling the claims arising from the accidents. The plaintiffs argued that they were third-party beneficiaries of the liability insurance policies; thus they were entitled to bring suit when the insurance companies breached their obligations to pay for injuries caused by their insureds. Citing *Bennett*, the court found the plaintiffs were not third-party beneficiaries because they were not parties to the insurance contracts; thus they were owed no duty by the insurers.[18] In addition, the court rejected the plaintiffs' argument on the basis that they had failed to show the insurance companies intended to benefit third parties injured by their insureds' negligence.[19]

II. EROSION OF THE DIRECT ACTION RULE IN INDIANA

A. *ARAIZA V. CHRYSLER INSURANCE CO.*

Despite the long history of the direct action rule in Indiana and the recent cases upholding its applicability, several recent decisions have created exceptions to its strict application. In *Araiza v. Chrysler Insurance Co.*,[20] Sebastian Araiza was injured as a passenger in a one-car accident and subsequently brought a negligence action against the driver of the vehicle and his own underinsured motorist carrier. The driver of the car did not appear in the action, despite Araiza's counsel's communications with the driver's insurance company, and Araiza was awarded a default judgment against the driver.

Araiza then instituted proceedings to enforce the judgment, naming the driver's insurer, Chrysler Insurance, as a defendant. Chrysler appeared, claimed no coverage for the driver, and moved to set aside the default judgment.

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[14] 716 N.E.2d 993 (Ind. Ct. App. 1999).

[15] *Id.* at 1002.

[16] *Id.*

[17] 751 N.E.2d 757 (Ind. Ct. App. 2001).

[18] *Id.* at 760.

[19] *Id.* at 761.

[20] 699 N.E.2d 1162 (Ind. Ct. App. 1998).

Chrysler then filed a declaratory judgment action against the driver, Araiza, and Araiza's insurer. The cases were consolidated and the trial court denied Chrysler's motion to set aside the default judgment and set the matter for trial. Chrysler then moved for a default against its insured, which the court granted.

At the trial, Chrysler moved to dismiss the proceedings to enforce the judgment based upon its insured's default in the declaratory judgment action, and the trial court granted the motion, finding the judgment to be binding on Araiza and his insurer. The insurer appealed. The court of appeals concluded that the trial court failed "to determine Araiza's rights as an injured party or Chrysler's obligation as it relates to him."[21] The court held that "Araiza had an interest in the policy proceeds which vested at the time of the accident."[22] The decision seemingly creating an entirely new interest under Indiana law, one whereby an injured party is granted an actionable interest in the policy proceeds from the time of the occurrence at issue. The result seems to dispense with the prerequisite that liability be determined before the attachment of any rights to a third-party beneficiary.[23] The decision reversed the trial court's decision to allow Araiza to present evidence that Chrysler's insured could have presented to determine coverage under the policy. Such a determination makes it difficult for insurers to protect themselves from liability for judgments due to their insureds' unavailability or failure to cooperate in the defense. The court's holding in that case not only allows the initiating injured party to take the place of the insured in challenging a coverage denial and attempting to collect a judgment under the policy, but also allows the initiating injured party to pursue coverage and the policy proceeds in the absence of a judgment because of the "vested interest" the court recognized in the case.[24]

B. *COMMUNITY ACTION OF GREATER INDIANAPOLIS, INC. V. INDIANA FARMERS MUTUAL INSURANCE*

In a 1999 case, the Indiana Court of Appeals arguably further abrogated Indiana's direct action rule, allowing an injured third party to sue an insurer directly to determine coverage. In *Community Action of Greater Indianapolis, Inc. v. Indiana Farmers Mutual Insurance*,[25] Community Action of Greater Indianapolis, Inc. ("CAGI") brought suit against a general contractor and roofing subcontractor for failing to adequately secure its premises during a roofing project, thereby allowing the property to be flooded and sustain damage due to rain. CAGI also brought a count for declaratory judgment against the subcontractor's

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21 *Id.* at 1163.

22 *Id.*

23 *See* Moore, *supra*, note 1, at 30-31.

24 While the majority of jurisdictions continue to prohibit third-party direct action against insurers prior to a judgment against the insured, some other jurisdictions have held that even in the absence of a judgment against the insured, a third party may bring a declaratory judgment action against the insurance company. *See* ALLAN D. WINDT, 2 INSURANCE CLAIMS AND DISPUTES 4, § 8.08 (4th ed. 2003).

25 708 N.E.2d 882 (Ind. Ct. App. 1999).

liability insurer, Indiana Farmers Mutual Insurance, which had declined to provide coverage to the subcontractor (its insured) for the damages.

The trial court granted the insurer's motion to dismiss the declaratory judgment action and CAGI initiated an appeal of that decision, arguing CAGI had standing to pursue a declaratory judgment to determine coverage owed by the insurer to the subcontractor. The court of appeals referred to a lack of Indiana precedent on the issue, despite its recent holding in the *Araiza* case, and instead looked to Seventh Circuit federal case law.[26] The court concluded in accordance with the purpose of the Uniform Declaratory Judgment Act to "settle and afford relief from uncertainty and insecurity with respect to rights, status and other legal relations,"[27] the victim of an insured's tort has a legally protectable interest in the insurance policy before he has reduced his tort claim to a judgment. The court thus found that CAGI had standing to bring the declaratory judgment action against the subcontractor's insurer and reversed the trial court's decision and remanded the case for further proceedings.

Interestingly, the court of appeals explicitly stated that its decision was "not, as Farmers argues, contrary to this state's policy of prohibiting direct actions against an insurer where the injured party had no relationship with the insurer"[28] and that "[w]here the plaintiff is not suing the insurance company to establish that its insured committed a tort against the plaintiff, but rather is suing to establish whether the insurer can deny coverage or whether the insurance policy remained in effect, such suit is not a direct action against the insurer."[29] In doing so, the Indiana Court of Appeals implied that the purpose of the direct action rule, rather than being related to the relationship between insurer and insured through the insurance contract, is to protect insurance companies from the hostility of juries informed of the presence of coverage by the insurer's inclusion as a defendant in the lawsuit.

C. *WILSON V. CONTINENTAL CASUALTY CO.*

Most recently, in the 2002 case of *Wilson v. Continental Casualty Co.*,[30] the Indiana Court of Appeals had occasion to apply the exception to the direct action rule recognized in *Community Action*. In *Wilson*, Toni Wilson sued Michael Kendall, an Indiana attorney, for legal malpractice. Continental Casualty, Kendall's legal malpractice insurance carrier, defended Kendall subject to a reservation of rights. Wilson filed an action for declaratory judgment against

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26 The court of appeals looked to the cases of *Bankers Trust Co. v. Old Republic Insurance Co.*, 959 F.2d 677 (7th Cir. 1992), and *Truck Insurance Exchange v. Ashland Oil, Inc.*, 951 F.2d 787 (7th Cir. 1992).

27 708 N.E.2d at 885.

28 *Id.* at 886.

29 *Id.* (citing *Bankers Trust*, 959 F.2d at 682.) "This conclusion is not inconsistent with the refusal of most states to permit the victim of an insured injurer to sue the injurer's liability insurer directly. The reason for that refusal, a reason wholly unengaged by a case such as this, is to protect the insurance company from the hostility of juries." *Bankers Trust*, 959 F.2d at 682.

30 778 N.E.2d 849 (Ind. Ct. App. 2002).

Continental for a declaration that it was obligated to pay for damages awarded under the policy. Continental filed a motion to dismiss the declaratory judgment action based on the direct action rule. The trial court granted the motion to dismiss.

The Indiana Court of Appeals recognized the continued application of the direct action rule in Indiana, stating, "The prohibition of direct action suits against insurance companies in Indiana is well settled."[31] The court then went on to find that consistent with its holding in the *Community Action* case, "'the injured victim of an insured's tort has a legally protectable interest in the insurance policy before he has reduced his tort claim to a judgment.'"[32] The insurer attempted to distinguish that case, arguing that the conclusion reached should not apply because insurance coverage had not been denied and the insurer was merely defending under a reservation of rights. The court found that under the holding in *Community Action*, whether an insurer has denied coverage altogether or is merely defending under a reservation of rights, a plaintiff may bring a declaratory judgment action to determine whether the insurance carrier must indemnify its insured for damages awarded.

In explaining its holding, the court stated, "A plaintiff is at severe disadvantage when an insurance carrier chooses to defend an insured under a reservation of rights because at any time during the proceeding, even after the plaintiff has expended considerable time and resources, the insurance carrier can bring a declaratory judgment action to establish that it does not have to indemnify the insured defendant."[33] The court was not persuaded by Continental's argument that its holding would force the courts to allow third-party actions against insurers every time an insurer opted to defend under a reservation of rights. It agreed that this was a possibility, but found it to be a positive one, which prevented the "waste of parties' and judicial resources"[34] and gave all litigants the same knowledge of coverage, thereby potentially encouraging settlements and making "litigation outcomes dispositive, collectible, and credible."[35]

III. Implications and Unanswered Questions

Araiza and *Community Action* carved out a significant exception to Indiana's direct action rule, allowing declaratory judgment actions by third-party claimants against alleged wrongdoers' insurance carriers to determine coverage. *Wilson* confirms that the direct action rule applies only to claims for damages, not to declaratory judgment actions regarding coverage, even when an insurer defends under a reservation of rights. In reality, the direct action rule could aptly be referred to as the exception rather than the rule, as the only direct actions

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31 *Id.* at 851.

32 *Id.*

33 *Id.* at 852.

34 *Id.*

35 *Id.*

presently prohibited by third-party claimants against insurers are those for damages.

These cases represent a significant change in Indiana law, allowing third-party claimants to determine their interests in insurance proceeds before there is any determination regarding the insured's liability or the insurer's contractual duties under the insurance policy. These cases undermine the principles of legal duty and privity of contract that formed the basis of the direct action rule.[36] Instead, the court of appeals cited jury prejudice as the reason for the direct action rule and disregarded prior rationales for application of the rule.

These cases provide a powerful new tool for third parties to use to ascertain their rights and protect their right to a remedy. For example, if a client has a claim against someone and it is concerned that the wrongdoer does not have sufficient assets to satisfy a judgment, it need not wait until a potentially worthless judgment is rendered to determine if insurance coverage is available to satisfy the judgment. Rather, it may bring suit for declaratory judgment against the wrongdoer's liability insurer to determine whether coverage exists for the claim before concluding the liability lawsuit. If there is a question as to the extent of coverage available, the policy limits, or the covered insureds, the client presumably may seek a declaratory judgment to determine these issues before investing time and resources in the underlying suit only to be left with a judgment that may never be collectible.

Conversely, for insurance carriers and attorneys who represent them in Indiana, these cases are bad news. They expose insurers to numerous types of lawsuits on coverage issues—a potential declaratory judgment action for coverage literally every time there is a claim of liability against an insured. When the defendant is known or suspected to have insurance, and there is any question about coverage, the plaintiff now has every incentive to name the insurer in the case and assert a claim for declaratory judgment. Whether this will become common practice remains to be seen; recent activity does not seem to indicate any marked increase in the number of declaratory judgment actions filed due to the holdings in the aforementioned cases.

As with any evolving area of the law, of course, there are certain issues that have yet to be addressed by the Indiana courts. For example, must an insurer filing a declaratory judgment action join the plaintiff from the underlying suit in its suit for declaratory judgment against its policyholder? Is the fact that the underlying plaintiff's claim against the insurer is derivative of the policyholder's rights against the insurer sufficient protection for the insurer if the insurer does not join the underlying plaintiff in the declaratory judgment action? Will class action lawsuits require different treatment because of the potential for multiple declaratory judgment actions from each prospective class member? Answers to these and related questions will be worthy of note, and the further application of the principles and exceptions set forth by the Indiana courts will prove interesting because the future of the direct action rule appears uncertain.

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[36] *See* 289 N.E.2d 144 (Ind. Ct. App. 1972).