Steep penalties for wrongfully refusing to defend

By Peter S. Selvin

When an insurer wrongfully refuses to defend an insured under a liability policy the consequences to the insurer are harsh. Thus, under California law, when an insurer that has been found to have wrongfully breached its duty to defend, it will be barred thereafter from relying on exclusions to coverage which would have otherwise excused or negated its duty to indemnify its insured. See, e.g., *Amato v. Mercury Casualty Co.*, 53 Cal. App. 4th 825 (1997).

This principle incentivizes the insurer to meet its duty to defend by vigorously searching the underlying complaint for facts which create the potential for coverage. See, e.g., *Pension Trust Fund for Operating Engineers v. Federal Ins. Co.*, 307 F.3d 944, 951 (9th Cir. 2002); see also *K2 Investment Group, LLC v. American Guarantee & Liability Insurance Company*, 2013 WL 2475869 (NY App. 2013) (when a liability insurer has breached its duty to defend its insured, the insurer may not later rely on policy exclusions not contained in its initial disclaimer to escape its duty to indemnify the insured for a judgment against him).

Several recent cases illustrate that the California courts have extended this principle into the following situation: a carrier defends its insured under a reservation of rights, appoints so-called "panel" counsel, but refuses to fund the insured's independent counsel for the insured's defense, even though the "panel" counsel may face a conflict between the interests of the insured and the insurer.

The basic principle is that if the insurer's appointed or "panel" counsel is subject to a conflict of interest, then "the insurer *shall* provide independent counsel to the insured." Civ. Code Section 2860(a) (emphasis added).

Two key battlegrounds in the application of this statute have been (a) disputes about whether a conflict of interest sufficient to trigger the insurer's obligation to provide independent counsel has arisen, and (b) disputes about whether an insurer will be deemed to have waived its rights under Section 2860(c) to compel arbitration concerning the rates at which it has to fund the insured's defense by independent counsel.

As to whether the appointed counsel has a conflict of interest, the statute provides that "when an insurer reserves its rights on a given issue *and the outcome of that coverage issue can be controlled by counsel first retained by the insurer* ... a conflict of interest may exist." Section 2860(b) (emphasis added).

A recent example of such a conflict of interest scenario occurred in *Schaefer v. Elder*, 217 Cal. App. 4th 1 (2013). In that case a home builder, Elder, was sued by a customer, Schaefer, for breach of contract, negligence and other claims. Elder tendered the case to his insurer, CastlePoint, for his defense. Castlepoint appointed lawyers, the Koeller firm, under a reservation of rights to defend Elder in the lawsuit. Castlepoint also filed a declaratory relief action to determine whether the insurance policy provided coverage for the claims Schaefer made against Elder.

A key issue in the underlying suit was whether the workers who performed the construction work for Elder were his employees or simply independent contractors. This issue was also central to whether there was coverage under Elder's policy for Schaefer's claims because of a policy exclusion pertaining to work done by independent contractors.

In these circumstances, the court held that the foregoing fact pattern presented a conflict of interest sufficient to trigger Castlepoint's obligation to appoint independent counsel: "It is in Elder's interest to argue that the work was done by employees because the insurance policy would apply ... On the other hand, it is in Castlepoint's interest to argue that the work was done by independent contractors so that, in the declaratory relief action, Castlepoint could argue that Elder was not covered."

As a result of this conflict, Castlepoint was obligated to fund independent counsel in the underlying case and the Koeller firm was disqualified from any further involvement in the case.

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Although the appellate decision in Schaefer did not reach the consequences of the insurer's denial of independent counsel to its insured, two recent cases have effectively equated a carrier's referral to provide independent counsel with a wholesale breach of the duty to defend.

In *Montrose Chemical Corporation v. Century Indemnity Company*, 2010 WL 3566700 (2010), an insurer who provided coverage under a commercial general liability policy had been funding its insured's independent counsel, Latham & Watkins, presumably at full rates, in connection with certain environmental liability actions. Five years into the suit, the insurer reversed course and transferred Montrose's defense for handling by the insurer's appointed counsel.

Montrose sued the carrier contending that the carrier had breached its duty to defend by refusing to pay certain accrued billings by its independent counsel and also by transferring the defense to its appointed counsel. After Montrose obtained summary adjudication in its favor on these issues, the carrier sought to compel arbitration under Civil Code Section 2860(c) concerning the rates at which it would be prospectively funding Montrose's defense.

The trial court denied the carrier's petition to compel arbitration and the carrier appealed. The Court of Appeal affirmed.

Citing *Intergulf Development v. Superior Court*, 183 Cal. App. 4th 16, 20-22 (2010), the court determined that Montrose's insurer had waived its rights under Section 2860 by transferring the defense to its appointed counsel. Under such circumstances, the insurer was deemed to have waived its entitlement under Section 2860(c) to compel arbitration with its insured concerning the rates at which it was obligated to fund its insured's independent counsel.

The decision in *J.R. Marketing, LLC v. Hartford Insurance Company*, 216 Cal. App. 4th 1444 (2013), took this one step further. In that case, the insured's liability insurance carrier, Hartford, initially refused to provide a defense, but later reconsidered its initial coverage denial. It thereafter issued a reservation of rights and appointed "panel" counsel to handle the insured's defense. However, the carrier rejected its insured's request for the appointment and funding of independent counsel.

As in *Montrose*, the insured brought suit against its carrier claiming that the carrier had breached its duty to defend by denying its request for the appointment of independent counsel. Also as in *Montrose*, the insured secured summary adjudication in its favor. In that order, the court held that Hartford had owed a duty to its insured *arising from the inception of the underlying suit* to provide independent counsel. The order also provided that by having breached that duty, Hartford was barred from invoking its rights under Section 2860.

Although Hartford thereafter funded the insured's independent counsel for the duration of the suit, it then brought suit against those counsel, Squire Sanders, for recoupment of that portion of Squire Sanders' fees that Hartford deemed to be outside the scope of its contractual obligations under the relevant policy.

The trial court granted Squire Sanders' demurrer to Hartford's complaint without leave to amend and Hartford appealed. The Court of Appeal affirmed.

In the Court of Appeal's view, Hartford's suit against Squire Sanders was barred in part by reason of Hartford's own conduct. Citing *Atmel Corp. v. St. Paul Fire & Marine*, 426 F.Supp.2d 1039, 1047 (N.D. Cal. 2005), the court reaffirmed the principle that in order to take advantage of the provisions of Section 2860, an insurer must meet its duty to defend and accept tender of the insured's defense. "When, to the contrary, the insurer fails to meet the duty to defend and accept tender, the insurer forfeits the protections of section 2860, including its statutory limitations on independent counsel's fee rates and resolution [through arbitration] of fee disputes."

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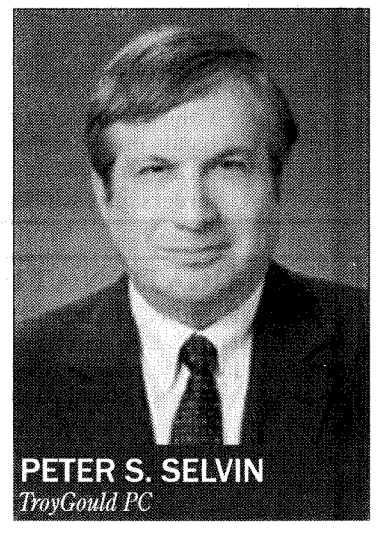
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BRIEFLY

U.S. District Judge Gary A. Feess will take senior status in March, opening up a judicial vacancy in the Central District of California. The country's most populous district is currently fully loaded with judges since the Senate confirmed U.S. District Judge Beverly Reid O'Connell in April. Senior status could give Feess the opportunity to reduce his caseload if he chooses, while opening up a vacancy on the federal bench. Feess was appointed by President Clinton in 1999.