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Don't miss the *"Buss"*

When insurers breach their duty to defend, they must reimburse costs for both covered and non-covered claims

Insurers found to have breached their duty to defend "mixed" actions, containing both covered and non-covered claims, will usually try to whittle down the damages they owe. One way they do so is by arguing that they are required to reimburse only the fees and costs incurred to defend potentially-covered claims. They are wrong. This article explains why California law requires breaching insurers to reimburse the entirety of the defense fees and costs their insureds were forced to incur, including those related solely to the defense of non-covered claims.

The *Buss* rule

The California Supreme Court held in *Buss v. Superior Court* (1997) 16 Cal.4th 35 [65 Cal.Rptr.2d 366], that an insurer must defend the *entire* action against its insured provided *any* claim is potentially covered by its policy. (*Id.* at 48.) The Court also held that a defending insurer may later seek reimbursement from its insured of any fees and costs allocated to claims not potentially covered by its policy.

The *Buss* Court explained why a defending insurer is obligated to defend both covered and non-covered claims. The insurer's duty to defend potentially covered claims is justified contractually, as an obligation arising out of the policy. (*Ibid.*) On the other hand, the insurer's duty to defend non-potentially-covered claims cannot be justified contractually, since the insurer never agreed to defend such claims. Instead, the Court explained, the insurer's duty to defend non-potentially-covered claims is justified "prophylactically," as "an obligation imposed by law in support of the policy." (*Id.* at 49.)

The *Buss* Court succinctly described the rationale for this rule in the following, much-quoted passage:

> To defend meaningfully, the insurer must defend immediately. To defend immediately, it must defend entirely.

(*Ibid.*)

- ***As applied to a breaching insurer***

While the *Buss* Court did not specifically address the question of what liability a breaching insurer has for defense costs, the answer flows logically from that decision and the application of basic principles of contract damages: A breaching insurer has to pay what it should have paid as a defending insurer, *i.e.*, the entire cost of defense. (See *Archdale v. American International Specialty Lines. Ins. Co.* (2007) 154 Cal.App.4th 449, 469 [64 Cal.Rptr.3d 632] ["[T]he injured party should receive as nearly as possible the equivalent of the benefits of the contract as he or she would have received, had the performance been rendered as promised."].)

Breaching insurers will sometimes argue that they can reduce the damages they have to pay by exercising a "right of reimbursement" pursuant to *Buss*. This, however, is clearly wrong. The California Appellate Court addressed this issue in *State of California v. Pacific Indemnity Co.* (1998) 63 Cal.App.4th 1535, 1549 [75 Cal.Rtpr.2d 69]. In *Pacific Indemnity*, a breaching insurer was ordered to reimburse the State of California for defense costs the State had already incurred in ongoing underlying litigation, and to undertake the State's defense going forward. In a passage directly contradicting the contention that a breaching insurer has reimbursement rights, the California Court of Appeal explained:

> *Buss* was premised on a "defend now seek reimbursement later" theory. By repudiating its duty to defend and providing no defense, Pacific Indemnity has nothing from which to seek reimbursement. *Buss* does not support Pacific Indemnity's theory that the State should contribute to attorney's fees. To the contrary, it unequivocally holds that the insurer's duty is to defend the action in its entirety.

(*Id.* at 1549, internal citations omitted.)

Moreover, a defending insurer's right of reimbursement is a *conditional* right. The *Buss* Court made clear that in order for a defending insurer to exercise a claim for reimbursement it must – and the *Buss* Court italicized the word *must* – affirmatively reserve its right to do so. (*Buss, supra*, 16 Cal.4th at 61, n. 27; see also *Griffin Dewatering Corp. v. Northern Ins. Co. of New York* (2009) 176 Cal.App.4th 172, 219 [97 Cal.Rptr.3d 568].) The Court explained the importance of the insurer's reservation in the following passage:

> Through reservation, the insurer gives the insured notice of how it will, or at least may, proceed and thereby provides it an opportunity to take any steps that it may deem reasonable or necessary in response– including whether to accept defense at the insurer's hands and under the insurer's control [references to earlier footnotes] or, instead, to defend itself as it chooses.

(*Buss, supra*, 16 Cal.4th at 61, n. 27.)

It would be utterly nonsensical if a defending insurer – *which has failed to reserve reimbursement rights* – would have to bear the entire costs of defense, while a breaching insurer – *which has also failed to reserve reimbursement rights* – is permitted to allocate between the costs of

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defending covered and non-covered claims.

Insurers will sometimes cite the California Supreme Court's decision in *Hogan v. Midland Ins. Co.* (1970) 3 Cal.3d 553 [91 Cal.Rptr. 153] as authority that a breaching insurer is permitted to allocate between covered and uncovered claims. *Hogan*, however, was decided almost 30 years before *Buss*, and what little was said in *Hogan* about allocation was dictum. *Buss*, by holding that insurers must provide a complete defense, now serves as the measuring stick for contractual damages owed by insurers in default of their defense obligations.

• Abundant authority endorses the view that a breaching insurer is obligated to reimburse its insured the cost of defending "non-covered" claims

While no published decision in California since *Buss* has squarely addressed the damages owed by an insurer for breach of its duty to defend a mixed action against its insured, the California Court of Appeal, several federal district courts, and leading insurance treatises have all expressed the view that the *Buss* rule entitles an insured to recover as contract damages the entirety of the defense costs it incurred.

A breaching insurer's obligation to reimburse all defense costs, including those related solely to the defense of non-covered claims, was directly addressed by the Court of Appeal in a non-insurance case called *Cassady v. Morgan, Lewis & Bockius LLP* (2006) 145 Cal.App.4th 220, 236 [51 Cal.Rptr.3d 527]. The *Cassady* decision is particularly informative because the appellate panel which decided it included Justice H. Walter Croskey, who is generally regarded as the state's leading jurist in the area of insurance law, and who concurred in the opinion written by Justice Aldrich. The *Cassady* court wrote, in relevant part, as follows:

> When an insurer *refuses* to defend an action in which a potential for coverage exists, the insured may recover defense costs, *including attorney's fees allocable to the defense of noncovered claims*, unless the insurer can prove they were unreasonable or unnecessary.

(*Id.*, second italics added; see also *Pacific Indemnity*, *supra*, at 1549.)

Several unpublished decisions from the federal district court have also addressed the issue and rejected a breaching insurer's attempt to allocate its insured's defense costs. (See, e.g., *Electronics For Imaging, Inc. v. Atlantic Mut. Ins. Co.* (N.D. Cal. May 14, 2007, No. C 06-03947 CRB) 2007 U.S. Dist. LEXIS 38058, *7 ["As defendant did not provide plaintiff with a defense, defendant is liable for plaintiff's costs and fees incurred in defending the underlying action, including those fees and costs incurred in defending claims that are not even potentially covered."]; *Thane Int'l, Inc. v. Hartford Fire Ins. Co.* (C.D. Cal. February 19, 2009, No. EDCV 06-1244 VAP(OPx)) 2009 U.S. Dist. LEXIS 13696, *16 ["[The insurer's] argument that its duty to defend should be apportioned with its insured . . . is contrary to California law."].)

California's leading secondary authority on insurance law is likewise of the view that a breaching insurer may not allocate defense costs. This issue is addressed in the following two sections of this treatise:

Damages for breach of duty to defend

> **Includes defense costs allocable to noncovered claims:** The insured may recover its defense costs, including attorney fees allocable to the defense of noncovered claims . . . .

(Hon. H. Walter Croskey, *et al.*, California Practice Guide: Insurance Litigation (The Rutter Group 2009) ¶ 7:691.15.)

> **No allocation between covered and noncovered claims:** As long as at least one claim was potentially covered, the insurer owes a duty to defend the entire action. By refusing to provide a defense, the insurer becomes liable for defense costs incurred by the insured allocable to claims *not even potentially covered* under the policy. [*State of Calif. v. Pacific Indem. Co.* (1998) 63 CA4th 1535, 1548 [75 Cal.Rptr.2d 69, 77]

(*Id.* at ¶ 12:652, italics in original.)

This view has also been adopted by insurance-law authorities outside of California. (See, e.g., 1-7 New Appleman on Insurance (Law Library Edition) § 7.06, n. 365 ["Based on [the *Buss*] rationale, in California, at least, the policyholder's recovery where the insurer does not defend should include reasonable and necessary fees and expenses to defend against claims within the underlying suit that are not potentially covered."]; see also Ostrager & Newman, Handbook on Insurance Coverage Disputes (15th ed. 2010) § 5.05[a] ["An insurer which breaches its duty to defend will be held liable to pay all defense costs, regardless of whether all of the claims are covered by its policy."].)

Thus, while the California Supreme Court has yet to squarely address the damages owed by a breaching insurer, judges and commentators agree that after *Buss* there can be only one logical answer: An insured is owed the entirety of the defense costs it was forced to incur as a consequence of the insurer's breach.

Moreover, having denied coverage, paid nothing, and failed to reserve a reimbursement right, a breaching insurer possesses no right of reimbursement. If it had such a right, it would, anomalously, be in a better position than a defending insurer which failed to reserve its rights, leading to an absurd and unfair result, something the law does not countenance.

Conclusion

Thus, under California law, a breaching insurer must reimburse its insured the entirety of the defense costs incurred – no less than what it would have owed had it defended – without any right of reimbursement.

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