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OPINION & COMMENT

Audit can turn wrongful insurance denial into business asset

By Gary Osborne and Dominic Nesbitt

A San Diego manufacturing company and its directors were sued for breach of contract, fraud and defamation.

The company tendered the lawsuit to two of its liability insurers, both of whom denied coverage. Over the next two years, the company spent almost \$2 million defending and ultimately settling the lawsuit.

After the case had concluded, the company's CEO hired an insurance lawyer to review the insurers' denial letters. The lawyer advised the company that both insurers had wrongfully denied coverage. The company then proceeded to sue both insurers and ultimately recovered the entire \$2 million it had paid to defend and settle the lawsuit.

This real-life experience of one local company is not unique. Businesses are routinely denied insurance benefits to which they are entitled. Remedies available to businesses that find themselves in this situation include the undertaking of an insurance-denial audit of a closed litigation file.

Defending against lawsuits can be an expensive proposition. Even a meritless lawsuit can cost a business hundreds of thousands -- perhaps even millions -- of dollars to defend. Liability insurance is intended to protect against this financial risk. While business liability insurance policies vary in the coverage provided (e.g., Commercial General Liability, Directors and Officers, Employment Practices Liability), they are all designed to cover claims alleged in business litigation. Even breach-of-contract and fraud claims are covered by some business liability policies.

Wrongful denials

When a business is sued and its insurer wrongfully denies coverage for the claim, the business suffers a double loss. First, it incurs legal fees and the costs of a judgment or settlement. And second, it has paid a substantial premium for an insurance policy that has turned out to be worthless.

The insurer, on the other hand, comes out way ahead. It retains the premium and pays nothing on the claim.

Rarely does a business ever challenge a denial letter or even have it reviewed by an insurance lawyer. More often than not, the letter is accepted at face value, filed away and forgotten.

California law provides a generous statute of limitations for liability claims against insurers who wrongfully deny insurance benefits. For example, if an insurer wrongfully refuses to defend a business against a third-party lawsuit, the business has four years in which to sue the insurer for policy benefits, and two years to sue for "bad faith." Importantly, these time periods often do not start running until the underlying lawsuit against the business has concluded.

This means a business that had a claim denied several years ago may still have time to challenge that denial in court.

A business' rights

A business whose claim has been wrongfully denied has the right to recover policy benefits and possibly also "bad faith" and punitive damages from its insurer.

Policy benefits usually consist of: (1) the cost of defending a third-party claim or lawsuit, and (2) the cost of paying a settlement or satisfying an adverse judgment.

The law provides that additional damages can be awarded to a business where an insurer denies a claim "unreasonably" or "without proper cause," i.e., in "bad faith." Bad faith conduct on the part of an insurer permits the business to recover not only policy benefits, but any other loss it suffered as a result of the insurer's wrongful denial. One such loss may be the attorneys' fees that the business incurs to challenge the insurer's denial. Under the law, these attorneys' fees can be recovered as bad faith damages.

Punitive damages may also be recoverable where an insurer is found to have acted with oppression, fraud or malice. Such damages are designed to punish a wrongdoer and to deter future wrongful conduct. Punitive damages can be substantial, often many times the amount the insurer owes in policy benefits.

The value of an insurance-denial audit

An insurance-denial audit is the process of examining a closed litigation file to determine whether a business is owed policy benefits on past claims where coverage was denied. An insurance lawyer will review the underlying litigation file, the insurance policy and the insurance company's denial letter.

The audit is designed to answer, initially, the following questions:

1. Was the insurance company's denial wrongful?
2. Does the business still have time to challenge the wrongful denial?

If the answer to these two questions is "yes," then the audit will next assess the viability of pursuing a claim against the insurer as well as the potential monetary recovery for the business.

As the story at the beginning of this article illustrates, the potential value of an insurance-denial audit can be substantial for any business that has been sued, had its insurance claim denied and been forced to pay out defense and settlement costs. An insurance-denial audit can transform an insurer's wrongful coverage denial, which would otherwise lie forgotten in a closed litigation file, into a valuable business asset.

Osborne and Nesbitt are founders and partners of Osborne & Nesbitt LLP in San Diego. The firm is dedicated solely to insurance coverage analysis and litigation on behalf of policyholders.