A Wrongful Denial of the Duty to Defend Can Have Surprising Value

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It can be frustrating when a liability insurer refuses to defend your client in expensive litigation. However, according to an old adage, "What seems like a curse may be a blessing."

As discussed below, in several respects, a policyholder may actually be put in a better position as a result of a wrongful denial than if its insurer had agreed to defend in the first instance.

1. CONTROL

The duty to defend gives the insurer absolute right to control its insured's defense. *See Gribaldo, Jacobs, Jones & Assocs. v. Agrippina Versicherunges A.G.,* 3 Cal. 3d 434, 449 (1970).

However, when an insurer breaches its duty to defend, it loses the right to control or manage its insured's defense. *Eigner v. Worthington,* 57 Cal.App.4th 188, 196 (1997) ("When an insurer wrongfully refuses to defend, the insured is relieved of his or her obligation to allow the insurer to manage the litigation and may proceed in whatever manner is deemed appropriate."). Thus, the policyholder whose insurer has breached its duty to defend has the right to control its own defense. It can select and hire its own defense counsel and experts, and can direct such counsel to litigate the action in a way that is designed to maximize the policyholder's interests.

2. RATES

A defending insurer can often control the hourly rates it pays to defend its insured by either (1) employing its own "panel" counsel, or (2) invoking the rate limitation provision in the *Cumis* statute. *See* Cal. Civ. Code §2860(c).

However, when an insurer breaches its duty to defend, "the proper measure of damages is the reasonable attorneys' fees and costs incurred by the insured in defense of the claim." *Marie Y. v. General Star Indem. Co.,* 110 Cal.App. 4th 928, 960-961 (2003); *see also* Hon. H. Walter Croskey, *et al.*, CALIFORNIA PRACTICE GUIDE: INSURANCE LITIGATION § 7:690, *et seq.* (The Rutter Group 2021).

Thus, the policyholder whose insurer has breached its duty to defend can not only choose its own defense counsel, but can also seek reimbursement of its defense counsel's reasonable fees and costs *at full rates.*

3. ALLOCATION IN A "MIXED ACTION"

In a "mixed action," involving both covered and non-covered claims, a defending insurer must defend the entire action. *Buss v. Superior Court,* 16 Cal. 4th 35, 49 (1997). Then, at the end of the case, a defending insurer that has reserved its right to do so can seek reimbursement from its insured for the costs of defending claims not even potentially covered by its policy. *Id.* at 50-51, 61, fn. 27.

However, a breaching insurer loses any right it might otherwise have had to allocate between the cost of defending covered and non-covered claims. *See, e.g.,* Hon. H. Walter Croskey, *et al.,* CALIFORNIA PRACTICE GUIDE: INSURANCE LITIGATION § 7:691.15 (The Rutter Group 2021) ("The insured may recover its defense costs, including attorney fees allocable to the defense of noncovered claims . . . unless the insurer can prove such fees were unreasonable or unnecessary.").

4. INDEMNITY FOR NON-COVERED SETTLEMENTS/JUDGMENTS

A defending insurer is only liable for amounts paid in settlement, or pursuant to a judgment entered against its insured, that are actually covered by its policy. The burden rests on the insured to prove what amounts fall within the scope of the basic coverage provided by its policy. *See Aydin Corp. v. First State Ins. Co.,* 18 Cal.4th 1183, 1188 (1998) ("The burden is on an insured to establish that the occurrence forming the basis of its claim is within the basic scope of insurance coverage.").

However, when an insurer breaches its duty to defend, the burden shifts to the insurer to prove what amount was paid to resolve non-covered claims. *See Gray v. Zurich Ins. Co.,* 65 Cal. 2d 263, 280 (1966) (holding that the insured will not be charged with the "impossible burden" of proving the extent of its loss caused by the insurer's breach where uncertain whether the judgment against the insured is rendered on a theory within the policy coverage). Once the insured has satisfied its initial burden of proving that at least a portion of the settlement or judgment involved compensation for damages attributable to a covered claim, the burden then shifts to the insurer to show what portion of the settlement or judgment is attributable to non-covered claims. If the insurer cannot satisfy this burden, then it must reimburse the entirety of the settlement or judgment. *See, e.g., Zurich v. Killer Music,* Inc., 998 F.2d 674, 679-

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680 (9th Cir. 1993) (stating that upon remand, "Zurich will have the opportunity to demonstrate that some portion, if not all, of the settlement amount is allocable" to non-covered matters); *see also Peterson Tractor Co. v. Travelers,* 2006 U.S. Dist. LEXIS 20050, *2 (N.D. Cal. Apr. 5, 2006) ("If [the breaching insurer] fails to provide evidence that demonstrates which portion of the settlement is attributable to covered claims, then the entire settlement is deemed to involve compensation for claims that were covered by the insurance policy.").

Depending on the circumstances of the case and the policyholder-defendant, these "benefits" of a wrongful denial can prove to be extremely valuable. So much so, in fact, that we have seen some policyholders identify a denial as wrongful at the front end of litigation, and then make the judgment call to refrain from challenging the denial until conclusion of the underlying lawsuit.

CONCLUSION

Thus, what seems like a curse *(i.e.,* a wrongful denial of the duty to defend) may be a blessing *(i.e.,* the benefits described above). To realize such benefits, however, a policyholder must first determine whether the insurer's denial was *wrongful.* For this reason, at the conclusion of expensive litigation, it is always worth taking a fresh look at whether the insurer's denial of a duty to defend was correct or incorrect. (Note: Many policyholder coverage lawyers will make such an assessment *at no cost* to determine whether they would be willing to pursue the insured's claim on a contingency fee basis.)

So the next time you conclude an expensive piece of litigation, ask this question: "Was the insurer's denial of a duty to defend incorrect?" If the answer to this question is "yes," then that denial could be transformed into a valuable business asset.

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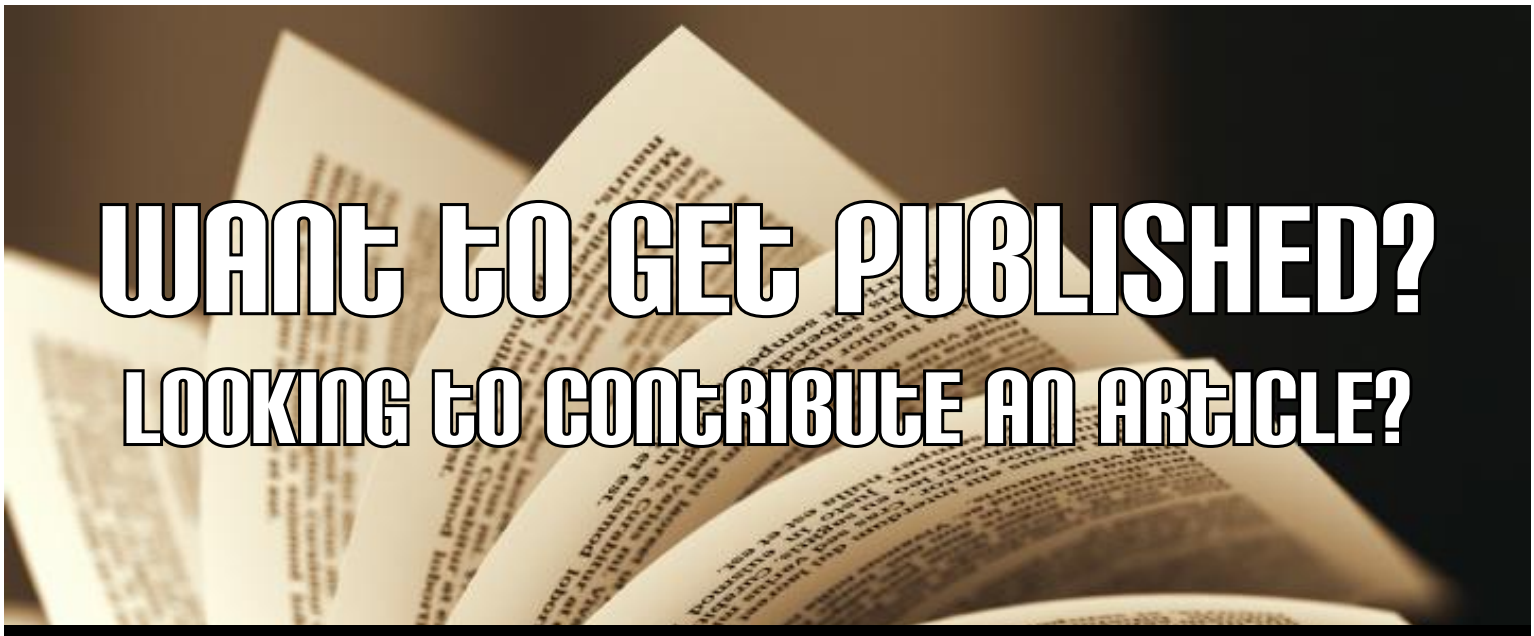

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