**REVISITING THE POLICY LIMITS DEMAND, PART ONE**
Wesley Lowe

**SO YOU HAVE A CASE IN SANTA CLARA COUNTY**
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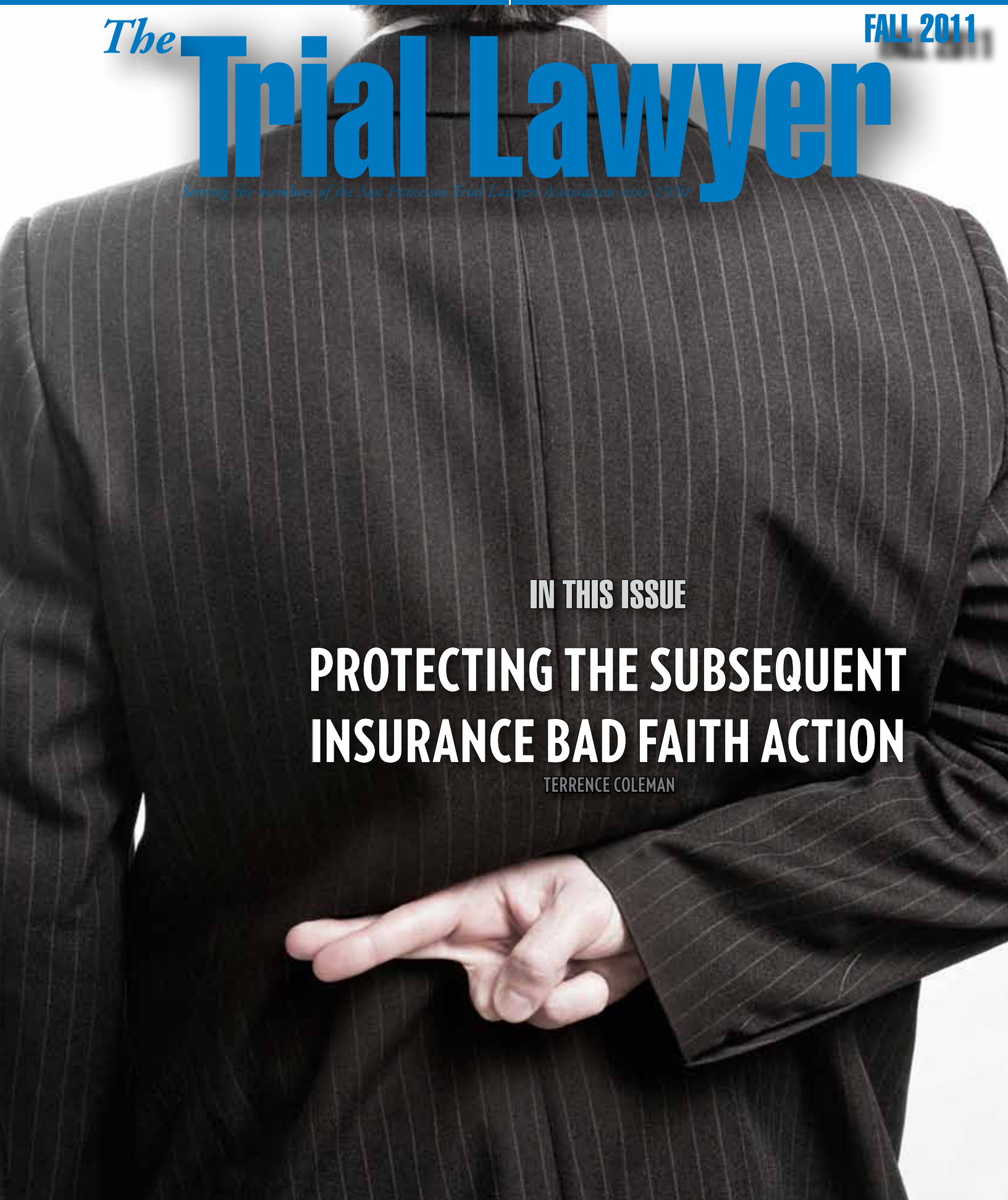

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## PROTECTING THE SUBSEQUENT INSURANCE BAD FAITH ACTION

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# PROTECTING THE SUBSEQUENT INSURANCE BAD FAITH ACTION

Having to file one lawsuit is bad enough. But when liability insurers act wrongfully, injured consumers often have to pursue two consecutive actions in order to obtain just compensation for their injuries — first, a personal injury action against the party that caused their injuries, and second, a bad faith action by assignment against that party's liability insurer. Most commonly, subsequent bad faith actions are required where the insurer either failed to defend its insured or refused to settle the underlying action within policy limits. Successfully navigating the waters of a subsequent bad faith action is not easy. Far too often, the end result is a Pyrrhic victory in which a large judgment against the insured is ultimately non-binding and not collectible against the defaulting liability insurer. Accordingly, here are some suggestions for what practitioners should and should not do during an underlying personal injury action in order to protect the viability of the subsequent bad faith case.

**Carefully Consider The Insurer's Coverage Denial**

Although liability insurers have a broad duty to defend, it is not limitless. It is paramount, therefore, to carefully consider the merits of the insurer's refusal to defend by obtaining the policy, denial, and to the extent possible, all communications between the insured, the agent or broker, and the insurer.

In the watershed case of *Gray v. Zurich Ins. Co.* (1966) 65 Cal.2d 263, the California Supreme Court held that an insurer owes a broad duty to defend its insured against a claim or suit in which there is any possibility that the claim might fall within the coverage. A defense duty is excused only where "the third party complaint can by no conceivable theory raise a single issue which could bring it within the policy coverage." (*Montrose Chemical Corp. v. Superior Court* (1963) 6 Cal.4th 287, 295)(emphasis added).) The determination whether the insurer owes a duty to defend usually is made in the first instance by comparing the allegations of the complaint with the terms of the policy. Facts extrinsic to the complaint can also give rise to a duty to defend when they reveal a possibility that the claim may be covered by the policy. (Id.) Importantly, any factual dispute impacting coverage establishes the defense obligation: "If coverage depends on an unresolved dispute over a factual question, the very existence of that dispute would establish a possibility of coverage and thus a duty to defend." (*Mirpad, LLC v. California Ins. Guarantee Assn.* (2005) 132 Cal.App.4th 1058, 1068.)

Often, the underlying defendant is insured under two or more policies. Two recent cases arising in the multi-insurer context are *Risley v. Interinsurance Exch. of the Auto. Club* (2010) 183 Cal.App.4th 196 and *Howard v. National Fire Ins. Co.* (2010) 187 Cal.App.4th 498. Each insurer's duty is separate and independent from the others. (*Risley v. Interinsurance Exch. Of the Auto. Club* (2010) 183 Cal.App.4th 196, 210.) "[W]here more than one insurer owes a duty to defend, a defense by one constitutes no excuse of the failure of any other insurer to perform." (*Wint v. Fidelity & Cas. Co.* (1973) 9 Cal.3d 257, 263.)

**Do Not Enter Into A Stipulated Judgment**

Where an insurer wrongfully fails to defend, the insured no longer has obligations to the insurer and is free to enter into the best bargain he can with the plaintiff. The Court in *Pruyn v. Agricultural Ins. Co.* (1995) 36 Cal. App.4th 500, explained the options available to such an insured. Essentially, there are two. First, he may enter into a stipulated judgment, obtain a covenant not to execute and seek to recover the judgment against the insurer. In this instance a rebuttable presumption is created that the judgment is valid and enforceable. (Pruyn, supra, 36 Cal.App.4th at 515.)

A stipulated judgment, therefore, is not necessarily binding on the insurer. In the subsequent bad faith action, the insurer will seek to relitigate the underlying action. Although it may be tempting to enter into a stipulated judgment to avoid the cost and time of having the court or arbitrator determine liability and damages, stipulated judgments are only presumed valid and enforceable. The insurer will be free to contest that presumption in the subsequent bad faith action.

The second option – and this is the far better course –

is to permit the matter to be submitted in an uncontested proceeding to a court and permit judgment to be entered. This may be accompanied by a covenant not to execute. Here, there is no presumption. The judgment is final and binding. An insurer cannot challenge the judgment. It waived its right to do so by breaching the duty to defend:

These circumstances [a default or uncontested trial] necessarily involve significant independent adjudicatory action by the court, thus mitigating the risk of a fraudulent or collusive settlement between an insured and the claimant. Final judgments entered under either of these circumstances are binding on the insurer which has wrongfully abandoned its insured and may be enforced directly under Insurance Code section 11580.

There is sound reason why this should be so. The insurer not only had a right to participate in and to control the litigation, it had a duty to do so. An insurer which has wrongfully abandoned its insured should not be heard to complain or allowed to relitigate the trial court's judgment merely because the default or uncontested proceedings followed, and were related to, an agreement between the insured and the claimant. Whatever the terms of the settlement, the entry of judgment was based on an independent review and adjudication of the evidence by the trial court. An insurer which has breached its contract is properly bound by the result of such trial proceedings and will not be heard to raise the policy's "no action" clause in defense.(36 Cal.App.4th at 517.) (fn. omitted) (Emphasis added.)

Moreover, such a judgment is binding even where it is ultimately determined there is no coverage so long as there was an erroneous refusal to defend. (*Amato v. Mercury Cas. Co.* (1997) 53 Cal.App.4th 825, 833 ("the insurer is liable on the judgment and cannot rely on hindsight that a subsequent lawsuit establishes noncoverage").

Notwithstanding entry of a judgment following an uncontested trial, insurers may still claim the settlement and resulting judgment was the product of "fraud and collusion" and therefore invalid. While the Pruyn court cautioned against "those trial proceedings which are clearly a patent sham collusively designed to create a judgment for which liability insurance coverage would then exist," citing the decision in *Lipson v. Jordache Enterprises, Inc.* (1991) 9 Cal.App.4th 151, 154–156, the conduct necessary to permit an insurer to avoid liability on this basis is quite extreme. In Jordache, for example, the parties amended the complaint four days before trial to include a cause of action for defamation in order to bring the action within the insurer's policy. By the time the insurer was given notice of the amended complaint and attempted to provide a defense, judgment had already been rendered against its insured. (9 Cal. App.4th at 154.)

**Be Careful With The Assignment And Covenant Not Execute**

Numerous and complicated issues arise when drafting an appropriate settlement agreement that includes an assignment of the defendant-insured's bad faith claim and a covenant not to execute. There is no single agreement that will be appropriate in all circumstances. It may be appropriate to condition the covenant not to execute on the insured's participation and cooperation in the subsequent bad faith action. This may be particularly important in light of the fact that purely personal claims, such as claims for emotional distress damages and punitive damages, are not assignable. (*Murphy v. Allstate Ins. Co.* (1976) 17 Cal.3d 937, 942.) The only way such claims can be pursued is in a single action against the insurer brought by both the judgment creditor and judgment debtor. Potential conflicts of interest must therefore be carefully considered and addressed.

*"Successfully navigating the waters of a subsequent bad faith action is not easy. Far too often, the end result is a Pyrrhic victory in which a large judgment against the insured is ultimately non-binding and not collectible against the defaulting liability insurer."*

**Policy Limit Demands And Excess Verdicts**

The implied covenant of good faith and fair dealing obligates insurers "to make reasonable efforts to settle a third party's lawsuit against the insured. If the insurer breaches the implied covenant by unreasonably refusing to settle the third party suit, the insured may sue the insurer in tort to recover damages proximately caused by the insurer's breach." (P*PG Industries, Inc. v. Transamerica Ins. Co.* (1999) 20 Cal.4th 310, 312.)

The insurer must settle within policy limits when there is a substantial likelihood of a recovery in excess of those limits . . . [T]he duty to settle is implied in law to protect the insured from exposure to liabil-

ity in excess of coverage as a result of the insurer's gamble -- on which only the insured might lose.

(*Kransco American Empire Surplus Lines Ins. Co.* (2000) 23 Cal.4th 390, 400-401.)

The California Judicial Council has adopted a jury instruction that clarifies the only permissible consideration in evaluating the reasonableness of a settlement demand is as follows:

A settlement demand is reasonable if [the insurer] knew or should have known at the time the settlement demand was rejected that the potential judgment was likely to exceed the amount of the settlement demand based on [the claimant's] injuries or loss and [the insured's] probable liability." (CACI 2334)

As a practical matter, it is nearly impossible for an insurer legitimately to argue a policy limit demand was excessive in amount. The verdict rendered against the insured "furnishes an inference that the value of the claim is the equivalent of the amount of the judgment and that acceptance of an offer within those limits was the most reasonable method of dealing with a claim." (*Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425, 431.)

Typically, therefore, insurers that have subjected their insureds to an excess verdict attempt to avoid liability by claiming defects in the demand letter, or the timing of the demand, justified its rejection. In order to establish insurer liability for an excess verdict, policy limit demands generally require the following:

- Joinder of all third-party claimants in the demand (see, *Kinder v. Western Pioneer Ins. Co.* (1965) 231 Cal.App.2d 894, 902);
- An offer to release all insureds (*Strauss v. Farmers Ins. Exch.* (1994) 26 Cal.App.4th 1017, 1021 (insurer may properly reject a policy limits demand that expressly did not include a complete release of all of its insureds);
- An offer within policy limits that is reasonable; and
- Affords an adequate opportunity for the insurer's investigation of liability and damages.

In *Howard v. American National Fire Ins. Co.* (2010) 187 Cal.App.4th 498, the Court of Appeal considered the scope of an insurer's duty to settle in a multi-insurer setting. In that case, American National claimed that it did not have an opportunity to settle within its $500,000 policy


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limits because the plaintiff's demand – $1.85 million – exceeded its limits even though the insured's coverage from other carriers also on the risk totaled nearly $4.3 million. The court rejected any such notion that liability insurers could work to immunize each other from bad faith liability in this manner:

When multiple insurance policies provide coverage, each insurer's obligation is to cover the full extent of the insured's liability up to policy limits. [Citation] American did not respond to the settlement demand with its policy limits and, had it and other insurers done so, could have settled the litigation. As the trial court observed, the law "cannot excuse one insurer for refusing to tender its policy limits simply because other insurers likewise acted in bad faith. If this were not the case, insurers on the risk could simply all act in bad faith, thus immunizing themselves from bad faith liability." (187 Cal.App.4th at 525.)

**Conclusion**

As trial lawyers, we have an obligation to our clients to push insurance carriers to pay promptly the fair amount on all claims. When carriers balk, intentionally merely negligently, we have the ability to make them pay for their folly. TL

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