FARELLA BRAUN + MARTEL LLP

Avoiding the "Top Ten" Mistakes in Obtaining Insurance for the Defense and Settlement of Third Party Lawsuits

We gave the above-entitled presentation at Farella Braun + Martel's MCLE Day on November 8, 2011. We used two hypothetical cases to highlight practical challenges you may face in dealing with insurance companies. While the practical issues are discussed in the context of defamation and shareholder derivative cases, they also are common in other contexts.

1. First Hypothetical Case (Defamation Counterclaim)

Your client sues its distributor for breach of contract and fraud for failing to account for all revenues for products sold pursuant to a distribution agreement. The distributor files a counterclaim, alleging that your client: (a) breached the distribution agreement by failing to pay amounts owed under that agreement; and (b) defamation, based on statements your client made in a press release about the distributor's alleged breach of contract.

Mistake #1: Failing to promptly tender the claim to the insurer.

The client should tender the claim to its CGL insurer as soon as possible. Defense costs incurred before tender might not be covered. *Buss v. Superior Court*, 16 Cal.4th 35 (1997). To deny coverage altogether based on late tender, the insurer must demonstrate that it suffered some prejudice as a result of the delay, *Scottsdale Ins. Co. v. Essex Ins. Co.*, 98 Cal. App. 4th 86 (2002), which can be difficult for it to do. However, there's no reason to take on the risk that the insurer will be able to establish that it was prejudiced by your delay.

While run-of-the-mill cases can be tendered to the CGL insurer by your client's broker with a so-called "short-form" tender letter, it is a better practice with more complex claims such as this one to have coverage counsel prepare a "long-form" tender letter. That letter will address certain coverage issues up-front. However, to avoid drawing too much attention to those issues, after coverage counsel has prepared the "long-form" tender letter, your client may consider sending the letter itself.

Mistake #2: Agreeing to the defense counsel rates that the insurer offers to pay.

As discussed in more detail below, your client most likely will have the right to choose its own defense counsel in this kind of case under California Civil Code § 2860. When the insured has the right to choose its own counsel, Section 2860 requires the CGL insurer to pay the billing rates "actually paid by the insurer to attorneys retained by [the insurer] in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended." However, it is unlikely the CGL insurer has ever defended a case such as this one without being required to pay for the insured's chosen defense counsel. The insurer therefore probably won't be able to establish that it pays a certain rate in the ordinary course of business for this kind of case and will have to pay the full rate of your chosen defense counsel. Additionally, if the insurer breaches its duty to defend by failing to immediately and completely defend the insured, the insurer will not be able to rely on Section 2860. *Seagate Technology LLC v. National Union Fire Ins. Co.*, 737 F. Supp. 2d 1013 (N.D. Cal. 2010). Independent counsel's billing rates then are judged only by a market reasonableness standard.

Mistake #3: Agreeing to the insurer's demand during the underlying litigation to allocate defense costs between covered and non-covered counterclaims.

When an insurer has a duty to defend, it must defend the entire case. It cannot allocate defense costs between covered and non-covered claims before the end of the case. *Buss v. Superior Court*, 16 Cal. 4th 35 (1997). It can only seek to allocate after the underlying case has ended, and only with respect to defense costs that are ***solely*** allocable to non-covered claims. *Id*.

Mistake #4: Agreeing to the insurer's demand during the underlying litigation to allocate attorneys' fees and costs between the defense of counterclaims and the pursuit of affirmative claims.

Under California law, an insurer's defense obligation may extend beyond the precise boundaries of a particular complaint or case. Under settled California law, an insurer must pay for fees and costs that the insured shows are "reasonable and necessary . . . to avoid or at least minimize liability." This may include the insured's pursuit of its affirmative claims, *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal.4th 38 (1997), or even work outside the lawsuit. *Barratt American Inc. v. Transcontinental Ins. Co.*, 102 Cal.App.4th 848, 859-60 (2002). Thus, for example, your client's costs in pursuing its breach of contract and fraud claims may be covered if it can show that such costs were reasonable and necessary to the defense of the covered defamation counterclaim. *KLA-Tencor Corp. v. Travelers Indem.*

Co. of Ill., 2004 U.S. Dist. LEXIS 15376 (N.D. Cal. Aug. 4, 2004).

Mistake #5: Accepting the insurer's litigation guidelines for independent counsel.

If the insurer agrees to allow you to retain "independent counsel" under Section 2860, the insurer may request that you and your client agree to the insurer's billing guidelines. Such billing guidelines may seek to restrict the activities for which you can bill the insurer. For example, an insurer's proposed billing guidelines may prohibit internal conferences among attorneys in the firm, more than one attorney attending hearings or depositions, or billing for travel time.

You and your client are not required to blindly agree to the insurer's proposed billing guidelines, nor should you. You also should not ignore them. The insurer's proposal of billing guidelines presents you with an opportunity to engage in a discussion at the beginning of the case about what will and will not be permissible for you to do. You should engage in this discussion to clarify the rules governing your activities so that you can act in accordance with what the insurer has agreed to throughout the case. This may help you avoid disagreements with the insurer over what defense costs should be reimbursed during and after the case, likely allowing for more consistent and prompt payment of your bills.

When discussing the insurer's proposed billing guidelines, keep in mind that the insurer cannot interfere with defense counsel's exercise of professional judgment. *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 61 Cal. App. 4th 999 (1998). Therefore, you and your client should not (and are not required to) agree to the insurer's proposed billing guidelines to the extent they may interfere with your judgment regarding what action should be taken in your client's defense. For example, an insurer's attempt to limit discovery activities may be impermissible. *Id.*

2. <u>Second Hypothetical Case (Shareholder Derivative Action)</u>

Your individual client is sued in a shareholder derivative action for, among other things, breach of fiduciary duty based on alleged self-dealing in a corporate transaction.

Mistake #6: Moving to dismiss one or more causes of action without first considering the impact of the motion on the availability of coverage.

Defense counsel may see an opportunity to get rid of one or more causes of action in a complaint on the pleadings. Perhaps there is a clear statute of limitations defense or an obvious defect in the pleadings. Beware of doing so without first considering how obtaining a dismissal of those claims could impact your client's right to coverage. The causes of action of which you may want to seek dismissal might also provide the only basis on which to argue that your client is entitled to coverage.

Mistake #7: Assuming that a "conduct exclusion" (e.g., deliberate misconduct) bars coverage.

Causes of action that may be pled as being based on deliberate misconduct may also support liability based on some lesser degree of culpability. For example, a § 10(b)(5) claim could allege that your client engaged in deliberate fraudulent misconduct. But your client might be found liable on that claim at trial for making misstatements recklessly. While coverage for fraud may be excluded, reckless misconduct is not.

Some so-called "conduct" exclusions apply when the insured has "in fact" engaged in the misconduct alleged. Such an exclusion may allow the insurer to deny coverage before there has been an actual finding that the insured engaged in the alleged misconduct. However, many "conduct" exclusions only apply upon a "final adjudication" that the insured engaged in the prohibited misconduct. In that event, the exclusion would not apply until the very end of the case and only in the event of a final judgment based on a finding that the insured actually engaged in such misconduct.

Mistake #8: Failing to control communications with the insurer by (1) unnecessarily taking a confrontational posture with the insurer; or (2) failing to provide sufficient information to the insurer to allow it to evaluate the claim.

You will need to effectively manage the flow of information to and from the insurer. All insurance policies impose on the insured a duty to cooperate with the insurer by providing information regarding the defense and settlement discussions. While the insurer must show that it has been prejudiced by a breach of your duty to cooperate to escape its obligations under the policy, *Scottsdale*, *supra*, you should not give the insurer an opportunity to do so. Therefore, you should provide information as you are required and able to under the circumstances.

While you are obligated to provide certain information, you should view this obligation not as a burden that is to be resisted, but rather as an opportunity to shape the insurer's understanding of the case in a way that is favorable to your client's coverage position. Your goal in providing information is not to give as little as possible, but

rather to present it in such as a way that will persuade the insurer that the claims against your client are covered and should be settled with the insurer's money. Therefore, taking a confrontational approach with the insurer can be at odds with this goal and may complicate later efforts to settle the case.

To achieve the goal of persuading the insurer that it should ultimately fund (or at least contribute to) a settlement, you and your client should work together to ensure that you are effectively communicating with the insurer to achieve this goal. First, to the extent there is information concerning the defense that may harm your client's coverage position, you should seek to manage the communications with the insurer so that, even if the insurer must receive that information, it is receiving all the information necessary to support your client's position for coverage. Second, insurers need information to make payments. You and your client should work together to ensure that you are providing all the information the insurer needs to be able to fund or contribute to a settlement.

While much or all of the information should be communicated by defense counsel, coverage counsel can help manage this process by identifying what information must be disclosed to the insurer, what information should be disclosed to the insurer, and how that information should be presented. Coverage counsel can also address any coverage issues the insurer might raise.

Mistake #9: Failing to lay the groundwork with the insurer for settlement by (1) not opining that the insured has exposure in excess of policy limits, and that a settlement within policy limits would be reasonable, or (2) failing to work with plaintiff's counsel to educate them about the insurance realities.

Your client needs to directly address any coverage issues with the insurer before it comes time to settle. The insurer may believe it has strong coverage defenses and, as a result, be reluctant to fund or contribute to a settlement. The earlier and more directly your client addresses and resolves these coverage issues with the insurer the better.

After you have provided the insurer with the necessary information and your client has sought to resolve any coverage issues to the extent possible, the insurer must understand the consequences of failing to fund or contribute to a settlement. Under California law, an insurer is required to fund or contribute to a settlement that is reasonable and within policy limits. *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal. 4th 489 (2001). Therefore, it is essential for defense counsel to present to the insurer that the proposed settlement would be reasonable given the facts of the case and the likely trial outcomes.

To gain more leverage, you may seek to persuade the insurer that failing to fund or contribute to the proposed settlement may lead to a judgment against your client in excess of policy limits. If the proposed settlement is reasonable and within policy limits, the insurer refuses to fund it, and there later is an excess judgment rendered against your client, the insurer will be liable for the entire judgment including any amounts in excess of its policy limit. *Crisci v. Security Ins. Co. of New Haven, Conn.*, 66 Cal.2d 425 (1967). The risk of excess of limits (or bad faith) exposure provides a strong incentive to the insurer to assist in completing the proposed settlement.

To this end, it may be necessary to communicate with counsel for the plaintiffs in the underlying action about the insurance realities your client is facing. You should not communicate with the plaintiffs' attorneys in a way that prejudices the defense or increases the strength of their case against your client, but plaintiffs' counsel need to understand (often with the help of a mediator) the impediments to settlement.

Mistake #10: Failing to seek the insurer's consent to the settlement.

Your client's insurance policies will require the insurer's consent to any settlement as a condition to coverage. Nearly every such policy prohibits the insured from incurring any obligation or making any payment without the insurer's prior consent. Under California law, the insurer need not show that it suffered any prejudice from its lack of consent to avoid coverage. *Jamestown Builders, Inc. v. General Star Indem. Co.*, 77 Cal. App. 4th 341 (1999). Therefore, if your client's insurer is not funding or contributing to a settlement, you must seek its consent before agreeing to the settlement.

If you do not expect the insurer to consent, you may still be able to salvage your settlement. First, even if the insurer disagrees with your position about the existence of coverage or the reasonableness of the settlement and refuses to consent, you may be able to persuade the insurer to agree not to assert lack of consent as a defense in a later coverage action. Second, the insurer may agree to fund some or all of the settlement under a reservation of rights to later seek reimbursement from your client on the ground that there is no coverage. *See Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 15 Cal.3d 9 (1975). While you might appear to be settling one lawsuit and buying another one with this arrangement, it has the benefit of capping all parties' liabilities and requiring the insurer to chase your

client for reimbursement. It also may turn out to be an interim step to an eventual settlement with the insurer.