



# When the insurer denies coverage and refuses to defend

*A look at the process and the law of assignment, covenant and judgment for insurance claims*

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This article covers the critical steps that a plaintiff or claimant should take when the liability insurer for the insured defendant denies coverage and refuses to defend. When the insurer has denied coverage and refuses to defend and when the only asset of the insured is an insurance policy, the only realistic path to recovery open to the plaintiff may be settling with the insured in exchange for a covenant not to execute (other than against the insurance policy) and some form of judgment which can be used to pursue the liability insurer in a subsequent lawsuit.

The situation addressed in this article must be distinguished from situations where the insurer has provided a defense (with or without a reservation of rights) or where the defending insurer has breached the duty to settle by rejecting a policy limits demand. If the insurer has provided a defense, the parties cannot stipulate to a judgment without the insurer's consent. (*Hamilton v. Maryland Casualty Co.* (2002) 27 Cal.4th 718.) If the insurer fails to accept a policy limits demand and the plaintiff obtains a judgment in excess of the demand, the insurer may be held liable for the total judgment. (*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 659 (insurer's right to "negotiate and settle" under the policy is constrained by the implied covenant of good faith and fair dealing which obligates the insurer to accept reasonable settlement demands within the policy limits in order to avoid exposing its insured to

personal liability in excess of those limits).)

Under California law, a liability insurer owes a broad duty to defend its insured against claims that create a potential for coverage. (*Horace Mann Ins. Co. v. Barbara B.* (1993) 4 Cal.4th 1076, 1081; *Gray v. Zurich Ins. Co.* (1966) 65 Cal.2d 263, 276.) This broad duty encompasses claims that are "merely potentially covered" in light of the facts alleged. (*Buss v. Superior Court*, (1997) 16 Cal.4th 35, 46.) A breach of the duty to defend can lead to bad faith. A liability insurer's refusal to defend without proper cause may give rise to a tort cause of action for breach of the implied covenant of good faith and fair dealing. (*Amato v. Mercury Casualty Co.* (1997) 53 Cal.App.4th 825.)

Importantly, when the insurer wrongfully refuses to defend, it repudiates its obligations under the policy and leaves the insured to fend for himself. The insurer's denial of coverage and a defense frees the insured to make a reasonable settlement with the plaintiff, allow a judgment to be obtained against him or her, and then maintain (or assign) an action against the insurer for breach of its duties, all without the insurer's consent. (*Hamilton v. Maryland Casualty*, *supra*, 27 Cal.4th at 728.)

## **Allege claims and frame the lawsuit to establish a potential of coverage**

The plaintiff must first analyze the insurer's coverage position and determine whether the insurer owed a duty to defend its insured. This may involve determining whether plaintiff's claims fit or meet the standard definition of "bodily

injury" and/or "property damage" or can be construed or characterized to fall outside the scope of some exclusion or condition precedent. Further the plaintiff must inquire about whether the insured is covered under an umbrella policy that broadens coverage by including "personal injury coverage." Personal injury coverage is a specific type of coverage that oddly does not mean personal injuries in the ordinary sense. Rather the coverage extends liability protection against certain enumerated offenses including intentional torts. Thus, the umbrella policy usually provides that "personal injury" means injury, *other than* "bodily injury," arising out of one or more of the following offenses: (a) false arrest, detention or imprisonment; (b) malicious prosecution; (c) the wrongful eviction from, wrongful entry into, or invasion of the right of private occupancy of a room, dwelling or premises, *etc.*

After the coverage issue or issues have been analyzed and weighed, the plaintiff should allege claims and causes of action in a way that maximizes a potential of coverage. This means including allegations of negligence and unintentional conduct in the general allegations and first causes of action so that they are the focus of the complaint. The goal is to attempt to head off the inevitable argument in the subsequent lawsuit against the insurer that such allegations were only "tacked on" as an afterthought in order to "manufacture coverage." Plaintiffs in general should resist the urge to pile on allegations of intentional or egregious conduct (at least at the outset of the complaint) because these may only support or be



used to justify the insurer's denial of coverage. If such allegations are crucial to the complaint, then include them towards the end.

### **File the lawsuit and make sure that the defendant has put the insurer on notice**

This is an obvious point but the plaintiff must file a lawsuit and cannot rely on the insurer's denial of coverage as a basis for settling with the insured. The reason for this is that the liability policy requires the plaintiff to obtain a judgment in order to sue the insurer. The insurance policy contains a "no action clause or condition" which typically provides that "no action shall lie against the company . . . under the liability coverage, until the amount of damages an insured is legally liable to pay has been finally determined by (1) judgment after actual trial, and an appeal, if any; or (1) agreement between the insured, the claimant, and the company." Further-more, California's direct action statute requires that the plaintiff obtain a judgment. Insurance Code section 11580 requires every liability policy delivered to any person in this state to contain "(2) A provision that whenever judgment is secured against the insured . . . in an action based on bodily injury, death or property damage, then an action may be brought against the insurer on the policy and subject to its terms and limitations, by such judgment creditor to recover on the judgment."

Once the plaintiff has filed the lawsuit, the insured defendant should tender his defense to the liability insurer pursuant to the notice provisions or policy conditions. These are typically entitled "Policy Conditions and Duties in the event of Occurrence, Offense, Claim or Suit." Although some cases hold that the insurer's denial of coverage relieves the insured of his duty to tender his defense, there is no harm in making the tender; it involves very little effort on the part of the insured defendant and, importantly, it crystalizes the coverage issues for all involved including the reviewing court.

### **Make policy limits demand**

Even though the insurer has denied coverage and wrongfully refused to defend, the plaintiff should still make a policy limits demand. While this may seem to be a futile gesture, it is important because it will protect plaintiff's right to eventually collect the full amount of the judgment, even if it is in excess of the policy limits. (See *Comunale v. Traders and General Insurance* (1958) 50 Cal.2d 654, 660; *Johansen v. CSAA* (1975) 15 Cal.3d 9, 15-16.) When, in addition to refusing to defend, the insurer also rejects a reasonable settlement offer within the policy limits, it may become obligated to pay more than its policy limits. (*Samson v. Transamerica Ins. Co.* (1981) 30 Cal.3d 220, 237.) When an insurer fails to accept a reasonable settlement offer after refusing to defend because of a mistaken belief that the policy does not provide coverage, the insurer is liable for any excess judgment entered against the insured, even if the insurer's belief in non-coverage is in "good faith." (*Comunale v. Traders and General Insurance, supra*, 50 Cal.2d at 660.)

### **Assignment of claims**

The next step is an agreement that the insured will assign all rights under the insurance policy to collect on the judgment to plaintiff, except for those rights which are not assignable (such as claims of punitive damages and emotional distress). The assignment should include any and all claims against the insurer, reinsurer, excess insurer, insurance agents and brokers, and brokerage services arising out of or related to plaintiff's claims, the failure to defend, the failure to pay the judgment, the failure to settle, and any other breach of duties by the responsible parties that cause damage to plaintiff and/or the insured.

Plaintiff and the insured can enter into the assignment before trial. An exchange of an assignment and a covenant not to execute can be made before trial, eliminating the insured's personal exposure to an

excess judgment. (*Hamilton v. Maryland Cas. Co., supra*, 27 Cal.4th at 732.) This procedure "frees the insured from monetary liability and, in turn, allows the plaintiff to step into the shoes of the insured and bring suit against the insurance company for *whatever claims the insured might have had.*" (*Executive Risk Indem., Inc. v. Jones* (2009) 171 Cal.App.4th 319, 325.) This explicitly allows the plaintiff to assert the insured's claims for failure to defend.

The duty to defend is a continuing duty, and thus the two-year limitations period to sue for bad faith failure to defend is tolled from the date of accrual of a cause of action to final judgment. (*Lambert v. Commonwealth Land Title Ins. Co.* (1991) 53 Cal.3d 1072.) Because the insurance agent or broker does not owe a duty to defend, the two-year limitations period is not tolled and begins to run when the insurer denies coverage and refuses to defend. Therefore, if the plaintiff suspects that insurance agents and brokers, brokerage services, and intermediaries are partially responsible for the lack of coverage because they misrepresented coverage, negligently advised or failed to disclose, or allowed the policy to exclude coverage for an essential part of the insured's business, then the plaintiff must file suit within two years of the date that the insurer denied coverage and refused to defend.

Last, as part of the assignment, plaintiff should have the insured waive the attorney-client privilege so that the insurer's entire claim file can be obtained in discovery. It may also be advisable to have the insured agree to cooperate since some cooperation on his part will be necessary in the subsequent litigation.

### **Covenant not to execute vs. covenant to limit execution**

Although courts have approved the covenant not to execute, the plaintiff to be safe should consider a covenant to limit execution which gets the parties to the same place but avoids a potential trap. The potential trap is that liability insurance policies are indemnity policies.



That means that the insurer has to reimburse or pay the insured for any sums that the insured is “legally obligated” to pay, or for which it is obligated to pay because it failed to provide a defense. (*Amato v. Mercury Casualty*, *supra*.)

If the insured is found to owe nothing, there is no obligation to indemnify. From a purely logical standpoint, if the insured reaches an agreement with the plaintiff to eliminate any obligation to pay the plaintiff, then there is no longer anything to indemnify. Thus, it could be argued that a covenant not to execute eliminates the carrier’s obligation to pay any judgment. In fact, some unpublished and de-certified cases have reached that very conclusion. In order to avoid this trap, the plaintiff and insured should consider a covenant to limit execution, which limits the plaintiff’s right to collect against the defendant/insured’s assets to the *insurance assets*, and any claims against any insurance professionals, such as insurance agents and brokers etc. Thus, some of the insured’s assets are still “on the line” and “at risk,” but all other assets are protected.

### **Judgment must be reasonable and free of fraud and collusion**

The final step in the process is to decide how plaintiff will obtain judgment against the insured. The principal goal here is to obtain a judgment in a reasonable amount that is free of fraud and collusion because a judgment obtained as a result of an assignment can be attacked usually on only two grounds, i.e., the amount is unreasonable and the result was the product of fraud or collusion. Collusion has been defined as “the existence of fraud of some kind, the employment of fraudulent means or of lawful means for the accomplishment of unlawful purpose, a secret combination, conspiracy or concert of action between two or more persons for fraudulent or deceitful purposes.” (*Xebec Development Partners Limited v. National Union Fire Ins. Co.* (1993) 12 Cal.App.4th 501.)

One way to obtain judgment is for the plaintiff to try the case to the court with the defendant either not appearing and not participating in the case, or participating in a limited fashion. This can be expensive (since the case is presented) and if there are any liability or damage issues, the result can be more unpredictable. However, the advantage to such an approach is that whatever judgment is obtained cannot be realistically attacked as collusive. An intermediate alternative is to stipulate to have the case heard by a retired judge, or an arbitrator appointed to sit as a judge pro tem or as part of a judicial arbitration. This may be less expensive, and the outcome is somewhat more predictable since the parties would know who is making the judgment. As a final alternative, the parties can also stipulate to a judgment, and have a court make a finding that the amount of the judgment was in good faith. (See *Pruyn v. Agriculture Ins. Co.* (1995) 36 Cal.App.4th 500, 515 (insured who is abandoned by its liability insurer is free to make the best possible settlement, including a stipulated judgment with a covenant not to execute).)

As a general rule, the greater the amount of judicial scrutiny or involvement when the judgment is created, the better the chances are that the judgment will survive the inevitable attack by the insurer that the judgment was the product of collusion. If there is sufficient judicial participation or supervision that mitigates the risk of fraud or collusion, the insurer will be bound by the judgment. (*Id.* at 516-517.) The reason is that “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 . . .” (*Ibid.*)

The safest, least risky course is to exchange a covenant to limit execution for an assignment of the insured’s cause of action for bad faith, without settling the underlying action and instead allowing

the case to proceed to judgment. This has been endorsed by the Court in *Hamilton v. Maryland Casualty Co*, *supra*, 27 Cal.4th 718. This is also the only course available to a plaintiff where the plaintiff seeks to recover against the insured’s insurance broker. (See *Valentine v. Membrilla Ins. Services, Inc.* (2004) 118 Cal.App.4th 462.)

There may be legitimate reasons to keep confidential the communications between the plaintiff and insured over the terms of any assignment, covenant and judgment. If this is a concern, the parties should consider utilizing a mediator to facilitate the negotiations. The mediation privilege should keep all communications, negotiations or settlement discussions confidential. (Evid. Code, § 1119.)

Once judgment is final (60 days after entry), plaintiff should make a demand to the insurer to pay the entire judgment. The insurer is almost certain to refuse, which then provides a basis for bringing suit for bad faith refusal to pay a final judgment against the insurer under *Hand v. Farmers* (1994) 23 Cal.App.4th 1847 (once having secured a final judgment for damages, [the insured’s judgment creditor] becomes a third-party beneficiary of the policy).

### **Damages for refusal to defend, failure to pay, and broker negligence**

An insurer that breaches its duty to defend without a reasonable basis for doing so is liable in tort for all damages that proximately result. (*Amato v. Mercury Casualty Co.*, *supra*, 53 Cal.App.4th 825.) Plaintiff does not have to prove that there was indemnity coverage under the policy. Plaintiff simply has to prove that there was a duty to defend and that a consequential damage of the failure to provide a defense was the judgment. (*Id.* at 833.) Plaintiff can recover the full amount of the excess judgment under both tort (*Amato v. Mercury Casualty Co.*, *supra*) and contract (*Archdale v. American International Specialty Lines* (2007) 154 Cal.App.4th 449, 467) theories.



Plaintiff can also recover attorney fees for seeking to collect on the judgment because the right to recover *Brandt* fees is fully assignable. (*Essex Insurance Co. v. Five Desire Dye House* (2006) 38 Cal.4th 1252, 1264-1265.) These fees are owed because plaintiff is seeking to recover the benefits of the contract, i.e., what the insurer owed to its insured as a matter of contract.

Plaintiff can recover bad-faith damages on his own unassigned claim for failing to pay the judgment after it became final and after a demand was made for payment. (See *Hand v. Farmers, supra*, (1994) 23 Cal.App.4th 1847.) These damages include emotional distress, attorney fees per *Brandt v. Superior Court* (1985) 37 Cal.3d 813 and punitive damages in that action.

Plaintiff can sue the insurer on a direct action per Insurance Code section 11580, but recovery would require plaintiff to prove actual coverage under the policy.

Plaintiff can also recover damages proximately caused by the agent or broker's negligence including attorney fees.

(See *Third Eye Blind Inc. v. Near North Entertainment Ins. Serv., LLC*, (2005) 127 Cal.App.4th 1311.



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