

## Civil Code § 2860 Rate Limitation Is Not Retroactive

### Introduction

Civil Code § 2860 codifies<sup>1</sup> the holding in *Cumis*<sup>2</sup> and expands upon it with an A + B = C formula by which the application of the statute is triggered if [A] the insurer has a duty to defend, [B] a disqualifying conflict of interest arises, and then [C] the insurer must pay for independent counsel to represent the insured.<sup>3</sup> However, Civil Code section 2860 is “inapplicable”<sup>4</sup> unless these prerequisites are satisfied irrevocably. If an insurer fails to satisfy these prerequisites an insurer “forfeit[s] its right to control the defense under Civil Code, section 2860.”<sup>5</sup> An insurer that initially fails to defend but later changes its mind to faithfully fulfill its duty to defend may not invoke the protections of section 2860 retroactively for the period of time that it did not unconditionally concede the existence of both a duty to defend and a disqualifying conflict of interest.

### Common Law Duty to Pay Counsel

The insurer’s promise to defend creates a duty that the insurer cannot lawfully discharge by itself because it is not licensed to practice law.<sup>6</sup> Thus, the only way the insurer may discharge its promise to defend is to delegate the task of conducting the defense to a licensed attorney. The duty to defend “entails the rendering of a service, viz., the mounting and funding of a defense (Citations) in order to avoid or at least minimize liability.”<sup>7</sup> “The insurers’ obligations are . . . rooted in their status as purveyors of a vital service labeled quasi-public in nature. Suppliers of services affected with a public interest must take the public’s interest seriously, where necessary placing it before their interest in maximizing gains and limiting disbursements.”<sup>8</sup>

### The “Immediate and Entire” Standard

A liability “insurer must defend immediately.”<sup>9</sup> “To defend immediately, it must defend entirely.”<sup>10</sup> “[T]he insurer has a prophylactic duty to defend the entire ‘mixed’ claim. That is because to defend meaningfully, it must defend immediately, and to defend immediately, it must

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<sup>1</sup> *Seltzer v. Barnes* (2010) 182 Cal.App.4th 953, 966 (ellipses omitted).

<sup>2</sup> *San Diego Federal Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358 (*Cumis*).

<sup>3</sup> See, *How Much Must an Insurer Pay Independent Counsel?, How Often Must an Insurer Pay Independent Counsel?*, and *Civil Code § 2860 - Limited Application - MoL and Civil Code § 2860 Protection Must Be Earned at DutytoDefend.com*

<sup>4</sup> *Handy v. First Interstate Bank* (1993) 13 Cal.App.4th 917, 926 (*Handy*).

<sup>5</sup> *State of California v. Pacific Indemnity Co.* (1998) 63 Cal. App. 4th 1535, 1543 (*Pacific Indemnity*).

<sup>6</sup> “No person shall practice law in California unless the person is an active member of the State Bar.” (Bus.&Prof. Code § 6125.)

<sup>7</sup> *Buss v. Superior Court* (1997) 16 Cal.4th 35, 46 (*Buss*); See, also, *Aerojet-General Corp. v. Transport Indemnity Co.* (1997) 17 Cal.4th 38, 58 (*Aerojet*); *Crawford v Weather Shield Mfg., Inc.* (2008) 44 Cal. 4th 541, 558; *Travelers Ins. Co. v. Leshner* (1986) 187 Cal.App.3d 169, 191.

<sup>8</sup> *Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 820-21.

<sup>9</sup> *Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 295 (*Montrose*).

<sup>10</sup> *Buss, supra*, 16 Cal.4th at 48.

defend entirely.”<sup>11</sup> A “mixed action” is one that alleges at least two of three possible types of claims: a claim that is: 1) clearly covered; 2) clearly not covered; or 3) potentially covered.<sup>12</sup>

### **Common Law Measure of Damage**

An insurer that fails to defend its policyholder is guilty of breach of contract for which the measure of damage is all costs of defense incurred by the policyholder, plus interest at the rate of 10%. “An indemnity against . . . liability . . . embraces the costs of defense against such . . . liability incurred in good faith, and in the exercise of a reasonable discretion.”<sup>13</sup> “If, after request, the [insurer] neglects to defend the [policyholder], a recovery against the [policyholder] suffered by him in good faith, is conclusive in his favor against the [insurer].”<sup>14</sup> A defaulting insurer “is liable for **all costs and attorneys’ fees** expended by [the policyholder].”<sup>15</sup>

### **An Insurer’s Reversal Does Not Cure a Prior Breach**

“‘[T]he duty to defend must be assessed at the outset of the case.’ (Citation omitted.) It follows that a belated offer to pay the costs of defense may mitigate damages but will not cure the initial breach of duty.”<sup>16</sup> Thus, when an insurer breaches its contract by failing to pay for its policyholder’s defense immediately and entirely, it becomes liable for all damages caused by the breach. A liability insurer does not exonerate itself from a prior breach nor are damages it previously caused reduced simply because it has changed its mind and belatedly agrees to defend.

### **Civil Code § 2860 Has a Rate Limitation**

Civil Code § 2860 protects a performing liability insurer in ways that common law does not. The statute has an hourly rate limitation provision that reads: “The insurer’s obligation to pay fees to independent counsel selected by the insured is limited to the rates which are **actually paid** by the insurer to attorneys retained by it in the **ordinary course of business in the defense of similar actions in the community** where the claim arose or is being defended.”<sup>17</sup>

However, an insurer that initially denies a duty to defend any particular lawsuit strongly implies that does not in fact actually pay dependent counsel to defend “similar actions.” Put another way, if the insurer does in fact actually pay dependent counsel to defend “similar actions”, it should have agreed to defend this particular action also. No language in the text of Civil Code § 2860 hints that its protections apply to an insurer that is in breach. Instead, the A + B = C formula of subsection (a) uses the mandatory word “shall” requiring insurers to “provide independent counsel to represent the insured.” The statute and applicable regulations requires that the insurer adequately fund the policyholder’s defense by payment of invoices generated by independent counsel at the applicable hourly rate<sup>18</sup> within 30 days.<sup>19</sup>

### **A Defaulting Insurer’s Payment of Reduced Rates Does Not Satisfy the Duty to Defend**

An insurer that previously breached its duty to defend immediately and entirely but then

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<sup>11</sup> *Aerojet, supra*, 17 Cal.4th at 60.

<sup>12</sup> “[A] ‘mixed’ action, [is one] in which some of the claims are at least potentially covered and the others are not.” (*Buss, supra*, 16 Cal.4th at 47.)

<sup>13</sup> Civ. Code § 2778(3).

<sup>14</sup> Civ. Code § 2778(5).

<sup>15</sup> *Hogan v. Midland National Ins. Co.* (1970) 3 Cal.3d 553, 558 (emphasis added).

<sup>16</sup> *Shade Foods, supra*, 78 Cal.App. 4th at 881; See, *CNA Casualty of California v. Seaboard Surety Co.* (1986) 176 Cal.App.3d 598, 605.

<sup>17</sup> Civ. Code § 2860(c) (emphasis added).

<sup>18</sup> See, *How Much Must an Insurer Pay Independent Counsel?* at DutytoDefend.com

<sup>19</sup> See, *How Often Must an Insurer Pay Independent Counsel?* at DutytoDefend.com

agrees to defend does not satisfy its obligation to the policyholder by paying reduced rates for the period of its breach. Paying too little “would force the insured to finance his own investigation and the defense of the lawsuit, and then to seek reimbursement in a second lawsuit against the insurance company. This, in turn, could not only impose an undue financial burden on persons who have purchased insurance protection, but it could deprive them of the expertise and resources available to insurance carriers in making prompt and competent investigations as to the merits of lawsuits filed against their insureds.”<sup>20</sup>

The insurer does not earn the advantages of § 2860 protection unless and until it agrees unconditionally<sup>21</sup> that both a duty to defend and a disqualifying conflict of interest exist. The statutory consequence of such an agreement is that the insurer “shall provide independent counsel to represent the insured.”

### **Public Policy Precludes 2860 Protection to Defaulting Insurers**

California law is clear that a defaulting insurer may not take advantage of the protection of Civil Code § 2860. Public policy considerations lie in support of this rule. “There is an important difference between the liability of an insurer who performs its obligations and that of an insurer who breaches its contract.”<sup>22</sup> The insurer cannot “take advantage of [its] own wrong.”<sup>23</sup>

### **The § 2860 Rate Limitation Does Not Apply Retroactively**

#### **A. Breach Forfeits 2860 Protection**

If a policyholder “is able to establish a breach of the duty to defend, its damages are not limited by California Civil Code § 2860. . . .’[t]o take advantage of the provisions of § 2860, an insurer must meet its duty to defend and accept tender of the insured’s defense, subject to a reservation of rights.’ (Citations omitted.) Here, it is undisputed that [the insurer] did not defend [the policyholder] in the [liability] Action, and thus the Court concludes defendant cannot avail itself of the protections and limitations set forth in § 2860.”<sup>24</sup> “[B]y its refusal to defend, [the insurer] had forfeited its right to control the defense under Civil Code, section 2860.”<sup>25</sup> “When [the insurer] refused plaintiffs’ tender of their appeal in the [liability] action, it breached the contract. Once [the insurer] wrongfully denied a defense, it gave up the right to control the litigation and could not insist that plaintiffs use [dependent counsel] in order for [the insurer] to cover attorney’s fees on appeal. . . . Before an insurer rejects a tender, it must make an adequate investigation of the facts. Failure to do so bars the insurer from denying the tendered defense, and subjects it to liability for the insureds’ full attorney’s fees and costs incurred thereafter with other counsel.”<sup>26</sup>

In *Hartford Cas. Ins. Co. v. J.R. Marketing* (2015) 61 Cal.4th 988, the California Supreme Court assumed without independently deciding that a trial court order as appropriate which ruled:

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<sup>20</sup> *Mullen v. Glens Falls Ins. Co.* (1977) 73 Cal.App.3d 163, 173-74.

<sup>21</sup> *Handy, supra*, 13 Cal.App.4th at 926.

<sup>22</sup> *Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 659.

<sup>23</sup> Civ. Code § 3517; “For every wrong there is a remedy.” (Civ. Code § 3523.) “Every person is bound, without contract, to abstain from injuring the person or property of another, or infringing upon any of his or her rights.” (Civ. Code § 1708.) “One must so use his own rights as not to infringe upon the rights of another.” (Civ. Code § 3514.)

<sup>24</sup> *Atmel Corp. v. St. Paul Fire & Marine Ins. Co.* (N.D.Cal. 2005) 426 F.Supp.2d 1039, 1047.

<sup>25</sup> *Pacific Indemnity, supra*, 63 Cal. App. 4th at 1543.

<sup>26</sup> *Stalberg v. Western Title Ins. Co.* (1991) 230 Cal.App.3d 1223, 1233.

“[the insurer] had breached its defense obligations by refusing to provide *Cumis* counsel until ordered to do so and by thereafter failing to pay counsel’s submitted bills in a timely fashion. . . . [A]s a result of its breach, [the insurer] would be precluded from ‘invok[ing] the rate provisions of Section 2860.’” (*Hartford Cas. Ins. Co. v. J.R. Marketing* (2015) 61 Cal.4th 988, 994.)

## **B. Summary**

Although unpublished,<sup>27</sup> one Court of Appeal opinion made the following analysis:

“‘The general measure of damages for breach of [the] duty to defend consists of the insured’s cost of defense in the underlying action, including attorney fees. [Citation.]’ (*Intergulf Development LLC v. Superior Court* (2010) 183 Cal.App.4th 16, 20.) This is so because “[a]n insurance company may not wrongfully refuse to defend its insured and thus force the insured into the position of having to engage outside counsel, and then, because the defense was not handled in a manner to the liking of the company, refuse to hold the insured harmless against payment of fees for all services reasonably performed in such defense.” (*Arenson v. National Auto. & Cas. Ins. Co.* (1957) 48 Cal.2d 528, 538.) Thus, even if the insurer could have provided a defense at its own expense at a lesser cost, if it breaches the duty to defend, it is responsible to pay for all of the attorney fees reasonably incurred by its insured in obtaining a defense.

“The rate limitations of section 2860 provide that ‘the insurer’s obligation to pay fees to the independent counsel selected by the insured is limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended.’ (Civ. Code, § 2860, subd. (c).) . . . The issue presented by this case is if this limitation on the fees the insurer must pay independent counsel applies *only* when the insurer is timely satisfying its duty to defend, or if, to the contrary, it also limits the amount the insurer retroactively must pay after it failed to timely satisfy the duty.

“Several California appellate opinions have reached the issue, and they have all decided the issue the same way: when the insurer breaches the duty to defend, and its obligation to pay defense costs would have otherwise been limited by section 2860, the section 2860 limitation *does not apply* to the attorney fees the insurer failed to pay. Instead, the insurer must pay the usual measure of damages for breach of the duty to defend, the reasonable attorney fees actually incurred by its insured in obtaining a defense. (*Janopaul K Block Companies, LLC v. Superior Court* (2011) 200 Cal.App.4th 1239, 1249; *The Housing Group v. PMA Capital Ins. Co.* (2011) 193 Cal.App.4th 1150, 1157; *Intergulf Development LLC v. Superior Court*, *supra*, 183 Cal.App.4th at p. 20. See also *Atmel Corporation v. St. Paul Fire & Marine* (N.D. Cal. 2005) 426 F.Supp.2d 1039, 1047.)

“There are at least two reasons why this is the correct result. First, it is mandated by the language of the statute. . . . [S]ection 2860 is not triggered at all unless there is first a duty to defend and a conflict of interest requiring the provision of independent counsel. Without the establishment of these requirements, there is no duty to provide independent counsel, and the cost limitations of section 2860 never come into play. ‘[The insurer] argues that [section] 2860 applies because *if* it had defended [the insured] in the [underlying a]ction, it would have done so

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<sup>27</sup> *City Art v. Superior Court* B256132. “[A]n opinion of a California Court of Appeal or superior court appellate division that is not certified for publication or ordered published must not be cited or relied on by a court or a party in any other action. “(Rules of Court, Rule 8.1115(a).)

under a reservation of rights. This argument misses the point, however, because as numerous courts have recognized, ‘[t]o take advantage of the provisions of [section] 2860, an insurer must meet its duty to defend and accept tender of the insured’s defense, subject to a reservation of rights.’ [Citations.] Here, it is undisputed that [the insurer] did not defend [its insured] in the [underlying a]ction, and thus the Court concludes defendant cannot avail itself of the protections and limitations set forth in [section] 2860.’ (*Atmel Corp. v. St. Paul Fire & Marine, supra*, 426 F.Supp.2d at p. 1047.)

“Second, policy reasons support the conclusion that section 2860’s rate limitations cannot apply retroactively to attorney fees incurred by the insured when the insurer was not providing a defense. ‘If [the insurer] owes any defense burden it must be fully borne [citation] with allocations of that burden among other responsible parties to be determined later. [Citations.] As the trial court here reasoned, an acceptance of [the insurer’s] position—that ‘insurers always can take advantage of [section] 2860 despite immediately failing to meet their burden to defend’—would encourage insurers to reject their *Cumis* obligations for as long as they chose because they knew they could invoke the limitations and remedies of section 2860 at any time.’ (*The Housing Group v. PMA Capital Ins. Co., supra*, 193 Cal.App.4th at p. 1157.)

“We note an additional policy reason for the result. As a general rule, an insurer who breaches the duty to defend is liable for the reasonable attorney fees incurred by the insured in obtaining a defense. If an insurer could retroactively rely on section 2860, an insurer that breached the duty to defend could reduce the damages it owed simply by establishing that it *also* breached the duty to provide independent counsel. This is nonsensical. An insurer that breached the duty to defend must make its insured whole with respect to defense costs reasonably incurred; an insured should not be left with partial recovery simply because the insurer *would have had* a conflict of interest requiring it to provide independent counsel, had the insurer accepted its duty to defend.

“We therefore conclude that section 2860 does not apply retroactively to attorney fees incurred prior to the time [the insurer] began paying defense costs. To the extent the trial court ruled that the section 2860 rate limitations applied when the duty to defend arose, it was in error.”