YOU DID . . . WHAT!

Looking at post-breach settlements under the light of a torch passed to third-party claimants

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Looking at Post-Breach Settlements Under the Light of a Torch Passed to Third Party Claimants

The Hypothetical:

D purchased a $1 million general liability insurance policy from GOT-U INS. CO.

D is sued by P.

P's complaint aggressively alleges many factual claims. Some of the claims, while not true, are at least potentially covered, thereby giving rise to GOT-U'S duty to defend the entire suit. Some of the claims are true but would never be even potentially covered. The uncovered claims create an exposure of at least $1.5 million, not including punitive damages.

D timely notifies GOT-U of P's suit. D requests a defense. However, GOT-U both denies coverage and fails to defend D, pointing to the claims that are not even potentially covered (ignoring the others).

D lacks the financial resources to defend itself and enters into a reasonable and non-collusive "Settlement, Assignment, and Limited Recourse Agreement" ("Settlement") pursuant to which (a) D settles with P for $1.5 million, (b) D assigns all assignable rights and claims against GOT-U to P and (c) P agrees that its sole recourse for collection will be limited to the recovery of assigned claims against GOT-U, not D's assets.[1]

P, as assignee, sues GOT-U.

Now, P alleges breach of contract and breach of the implied covenant of good faith and fair dealing arising out of GOT-U's breach of its duty to defend D. P claims, among other damages, the full amount of the Settlement, $1.5 million.

GOT-U conducts certain discovery including depositions of both D and P. GOT-U obtains facts which establish the falsity of P's claims that were at least potentially covered.

GOT-U'S defenses include the following:

[1] This hypothetical stipulates that emotional distress and punitive damages are not assignable at law. The assignability of punitive damages is dependent on the jurisdiction. See, United Heritage Property and Cas. Co. v. Farmers Alliance Mut. Ins. Co. (D. Idaho, Feb. 9, 2012, No. CIV. 1:10-456 WBS) 2012 WL 442881, at *5 ("Other states to have addressed this question have similarly held that claims for punitive damages can be assigned when they are based on otherwise assignable causes of action").

1. That breach of its duty to defend D, if any, did not "cause" the Settlement or the amount thereof;

2. The assignable damages are limited to fees and costs paid or incurred by D or, at best, are capped at policy limits subject to any retention;

3. That because D paid no money and was "immunized" against collection by the limited recourse term of the Settlement, D suffered no detriment or loss and P has no claim;

4. Relying on evidence obtained during discovery, GOT-U contends the Settlement was not "covered;" hence, P has no claim against GOT-U.

The Argument

I. First Defense: The insurer's breach of its defense obligation was not the legal cause of the Settlement

A. D had a right to mitigate GOT-U's breach by its settlement

It is widely recognized that when an insurer wrongfully fails or refuses to provide a defense to its insured, the insurer has materially breached the insurance contract, and the abandoned insured is entitled to enter into a reasonable and non-collusive post judgment settlement with the plaintiff and then maintain an action against the insurer to recover the amount of the settlement.[2] In addition, the majority of courts have recognized the insured's right to assign its action against the insurer in exchange for a covenant not to execute.[3]

One clear implication from the majority rule is that a contractual breach of the defense obligation "entitles" the insured to make a reasonable settlement. This means the causal link between breach of the defense obligation and settlement is a given. As explained by one court, "the unacceptable alternative would be to compel the insured, following the insurer's breach, invariably to force the dispute to trial and thus to risk additional (and

[2] See generally, D. Richmond, The Consent Judgment Quandary of Insurance Law, 48 TTIPLJ 537 (2013); C. Wood, *Assignments of Rights and Covenants Not to Execute in Insurance Litigation,* 75 Tex. L.Rev. 1373 (1997); J. Harris, *Judicial Approaches to Stipulated Judgments, Assignments of Rights, and Covenants not to Execute in Insurance Litigation,* 47 Drake L.Rev. 853 (1999).

[3] *Ibid., Strahin v. Sullivan,* 220 W.Va. 329, 342; 647 S.E.2d 765, 778 (2007) (explaining the majority of jurisdictions recognize the validity of a third-party's claim arising from a post-breach settlement with an assignment and covenant not to execute).

perhaps uninsured) exposure and to incur unnecessary expenditure of the insured's own money and of the state's overtaxed judicial resources."[4]

B. The anatomy of an *Isaacson* reimbursement claim

California recognizes an insured's post-breach right to enter into a reasonable, non-collusive settlement pre-judgment.[5] The anatomy of an *Isaacson* claim is made up of 4 points:

Point 1 - If an insurer, with notice of the pendency of the underlying action, wrongfully denied coverage or improperly refuses to provide its insured with a defense, the insured is entitled to make a reasonable settlement of the claim in good faith and then maintain an action against the insurer to recover the amount of the settlement.[6]

Point 2 - In a later action against the insurer, based upon a breach of the contractual obligation to provide a defense, a reasonable settlement made by the insured to terminate the underlying claim may be used as *presumptive evidence* of the [1] insured's liability on the underlying claim, and [2] the amount of such liability.[7]

Point 3 – To rely on the presumptions, an insured is required to establish three basic or foundational facts: (1) the insurer wrongfully failed or refused to provide coverage or a defense, (2) the insured thereafter entered into a settlement of the litigation which was (3) reasonable in the sense that it reflected an informed and good faith effort by the insured to resolve the claim.[8]

Point 4 – Once the insured presents these basic facts then the insured is entitled to an evidentiary presumption (under California Evidence Code §605), which affects the burden of proof at trial.[9]

Point 1 establishes causation. Point 2 makes clear the insured's presumed liability and amount of that liability flow from a reasonable settlement. This means the insured is never required to prove either his own liability or the amount thereof. Point 3 makes clear that a

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[4] *Pruyn v. Agricultural Ins. Co.,* 36 Cal. App. 4th 500, 529 (1995).

[5] *Isaacson v. California Ins. Guarantee Assn.* 44 Cal.3d 775 (1988); *Xebec Development Partners, Ltd. v. National Union Fire Ins. Co.,* 12 Cal.App.4th 549 (1993); and *Pruyn v. Agricultural Ins. Co.,* supra, 36 Cal. App. 4th 500.

[6] *Pruyn, supra,* 36 Cal.App.4th at 515 (citing and quoting *Isaacson,* 44 Cal.3d at 791).

[7] *Ibid.*

[8] *Pruyn, supra,* at 528.

[9] *Pruyn* at 529.

settlement is established as reasonable by the same kind of evidence as would support a good faith determination by the court that the settlement was in the "ball-park."[10] Point 4 makes clear that the insurer has an opportunity to challenge the settlement by showing that the settlement amount was unreasonable or fraudulent or collusive as not reached at arm's length.

II. Second Defense: The assignable damages are limited to fees and costs paid or incurred by D or, are capped at policy limits subject to any retention.

Upon breach of the defense obligation, the better-reasoned view is that there is no "cap" to limit damages to defense fees and costs paid or incurred

GOT-U's Second defense reflects perhaps the "majority view" that "[w]here there is no opportunity to compromise the claim and the only wrongful act of the insurer is the refusal to defend, the liability of the insurer is ordinarily limited to the amount of the policy plus attorneys' fees and costs."[11]

Recently, the Nevada Supreme Court, in response to a certified question submitted by the U.S. District Court for the District of Nevada, embraced the "minority view" as the better approach, *i.e.*, that damages for a breach of the duty to defend are not automatically limited to the amount of the policy; instead, the damages awarded depend on the facts of each case.[12]

In *Century Surety* the court held the majority view places an "artificial" limit to the insurer's liability. It reasoned that whereas a limits "cap" on damages is based on the duty to indemnify, "[a] duty to defend limited to and coextensive with the duty to indemnify would be essentially meaningless: insured's pay a premium for what is partly litigation insurance

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[10] *Tech-Bilt, Inc.v. Woodward-Clyde & Associates,* 38 Cal.3d 488 (1995) (provides trial courts with guidance in determining motions for good faith settlement under Cal. C. Civ. Proc. §877.6 which cuts off certain contribution rights of non-settling defendants). The *Tech-Bilt* court used the expression "ball park" to provide a short hand reference to a more specific, factor driven analysis for trial courts to follow when determining whether the settlement was "in the ball park" – motion granted; or when the settlement "out of the ball park" – motion denied. The factors to consider include a rough approximation of plaintiffs' total recovery, the amount of the settlement, the parties' financial conditions, and the existence of collusion, fraud or tortious conduct aimed to injure the interests of non-settling defendants. See, *Tech-Bilt, supra,* 38 Cal.3d at 499.

[11] *Comunale v. Traders & General Ins. Co.*, 50 Cal.2d 654, 659-60 (1958) (*Comunale*); see also *Emp'rs Nat'l Ins. Corp. v. Zurich Am. Ins. Co. of Ill.,* 792 F.2d 517,520 (5th Cir. 1986).

[12] See, *Century Surety Company v. Andrew,* 134 Nev. 819,823 citing, *Burgraff v. Menard, Inc.*, 367 Wis.2d 50, 875 N.W.2d 596, 608 (2016).

designed to protect . . . the insured from the expense of defending suits brought against him."[13]

Policyholders (or their assignees, like P) should consider the following arguments in opposition to the so-called majority view: First, to the extent *Comunale* ever was a statement of the majority view, it is now fragile. The flawed premise, quoted above, was *dictum.* So, the musing went, ***if*** the insured employs competent counsel there would be no ground for concluding that a judgment against the insured would have been for a lesser sum had the defense been conducted by the insurer's counsel. *Comunale's* 1958 *dictum* cannot be reconciled with the same court's later landmark *holding,* in *Gray v. Zurich Ins. Co.*[14] Recall, *Gray* held a breaching insurer liable for the full amount of a judgment against its insured.[15] Like GOT-U, the insurer in *Gray* tried to argue it only had to reimburse the insured's expenses in defending the third-party action, but not payment of the judgment. *Id.* at 279-80. The court rejected any such hard-and-fast rule because it would "impose upon the insured 'the impossible burden' of proving the extent of the loss caused by the insurer's breach." *Id.* at 280. Thus, the law's thoughtful evolution in just *eight short years* progressed rapidly from hypothesizing that an abandoned insured's counsel might not make a judgment "lesser" than insurer-selected counsel, on the one hand, to an adamant refusal to impose the "impossible burden" of proving the extent of loss, on the other.

Second, "[C]ourts have for some time accepted the principle that an insured who is abandoned by its liability insurer is '***free***' to make the best settlement possible with the third-party claimant, including a stipulated judgment with a covenant not to execute."[16] The analysis is not one of causation.

Third, GOT-U's suggestion that only defense expenses are recoverable upon breach of the defense obligation would contradict decades of established that law post-breach settlements give rise to presumptions of insureds' *liability* and the *amount* thereof. These presumptions would be meaningless if damages were limited to defense expenses.

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[13] *Century Surety Co. v. Andrew, supra,* 134 Nev. 819, 825.

[14] 65 Cal. 2d 263, 419 P.2d 168 (1966).

[15] *Gray, supra,* at 263.

[16] *Pruyn, supra,* 36 Cal. App. 4th at 515; also, *Samson v. Transamerica Ins. Co*., 30 Cal. 3d 220, 240-242 and *Isaacson v. California Ins. Guar. Assn*., 44 Cal. 3d 775, 791.

Finally, consistent with general contract principles, the insured should be entitled to consequential damages resulting from the insurer's breach of its contractual duty to defend.[17]

As case law has made plain, the proper measures of damage for contractual or tortious breaches of the defense obligation, codified in California by Civil Code §§ 3300 and 3333 respectively, apply so that the amount of a reasonable and non-collusive post-breach settlement is always sufficient to establish and quantify damage without any reference to "coverage."

III. Third Defense: Because the limited recourse agreement immunized D from having to fund the settlement, D suffered no detriment or loss and thus P has no claim

A. Policyholders should argue the "hypothetical of the innocent insured" to demonstrate why requiring "coverage" for post-breach settlements would eliminate incentives for settlement and waste judicial resources

Recall, P's numerous, aggressive allegations against D were ***not true*** with respect to the claims that were at least potentially covered. Put another way, given D's factual innocence, there was little or no chance GOT-U would ever be required to pay an adverse judgment against D pursuant to indemnity coverages.

It can be seen that if GOT-U'S position was ever written into the law so that reasonable post-breach settlements nonetheless had to be "covered," no just results would follow. There would be an obvious chilling effect on settlements: litigants would lose, courts would lose, and only insurers would "win."

P would have no incentive to settle, except for cash, because the assigned claims would have little value to the extent P, as assignee, had to prove "coverage."

If D was unwilling or *unable* to defend, the underlying P v. D lawsuit would proceed to default judgment. The insurer, having breached its defense duty, would lie-in-wait for prosecution of D's assigned claims, knowing it had saved money by not defending and ready to put some of its savings to use against P's assigned claims.

[17] See *Century Surety, supra,* at 825 (citing Restatement of Liability Insurance Sec. 48 (Am. Law Inst., Proposed Final Draft No. 2, 2018)).

Judicial resources would always be wasted either on the underlying P v. D suit that was forced to default or on trial of P's assigned claim, wherein P would be forced to the impossible burden of proving "coverage" for the post-breach settlement.

Thus, setting aside that P's second suit would be both pointless *and* virtually impossible to manage, GOT-U'S proposed rule would effectively remove *assignments with covenants not to execute* as established means of self-protection. Abandoned insureds, like D, innocent of alleged covered wrongdoing, would be far less able to settle actions because their Third-Party adversaries would be disinclined to accept assignments without potential value. At bottom, only insurers win—courts and insureds lose.

B. D, as Assignor of its rights against GOT-U, suffered a loss; that D made no actual Payment to P and is "insulated" from Personal Liability is irrelevant

GOT-U may argue that P has no bad faith claim against it. So it would go, because D paid no actual money and was "insulated" against personal liability by the post-breach settlement, he suffered no cognizable loss or detriment.

P's response should be simple and straightforward.

P should correctly acknowledge that breach of the implied covenant of good faith and fair dealing (bad faith) occurs if the insurer "acts unreasonably and without proper cause in failing to investigate a claim, refusing to provide a defense, or either delaying or failing to pay benefits due under the policy."[18] Also, P can readily concede "[Bad faith] is '*actionable'* because such conduct causes financial loss to the insured, and it is the financial loss or risk of financial loss which defines describing the unreasonable withholding of a policy benefit as a financial loss or risk of financial loss which defines the cause of action."[19]

However, the insured's right to a defense is a policy benefit, *to say the least*; it's also a primary right as important as the insured's right to indemnity and California courts have been consistently solicitous in the insured's expectations on this score. [20]

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[18] *Richards v. Sequoia Ins. Co.*, 195 Cal. App. 4th 431, 438 (2011).

[19] *Gourley v. State Farm Mut. Auto.*, 53 Cal.3d 121, 123.

[20] *Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th 287, 295-296 (1993); *Buss v. Superior Court*, 16 Cal. 4th 35, 45 (1997).

In the post-breach settlement D assigned its claims against GOT-U to P and "[a] thing in action is a right to recover money or other personal property by a judicial proceeding."[21] "A thing in action, arising out of the violation of a right of property, or out of an obligation, may be transferred by the owner."[22]

D's property rights, its claims against GOT-U, assigned to P, were not "gifted;" they were assigned in consideration of the limited recourse agreement (or covenant not to execute). D's economic loss was the transfer (assignment) of its claims including for breach of GOT-U's defense obligation and related bad faith—the amount of D's detriment or loss or damage, however described, will always equal the amount of P's recovery, if any, which will only be determined in the P v. GOT-U suit.

IV. FOURTH DEFENSE: Got-U's New Evidence, obtained in discovery conducted post-breach and post-settlement, tends to show P's potentially covered claims would never have been actually covered; hence the post-breach settlement is not "covered"

A. After violating its duty to defend, an insurer cannot by "hindsight" resort to newly discovered evidence that the post-breach settlement is not "covered"

1. The newly discovered facts are irrelevant because "coverage" measured by a standard applicable to indemnity is never at issue with respect to post-breach settlements

For a host of compelling reasons, actual "coverage," measured by the indemnity standard applicable to *judgments,* is completely irrelevant to post-breach settlements. As discussed in this paper, Policyholders (or their Assignees, like P) should argue as follows:

Point 1: Upon breach of the defense obligation, the insured had a right to enter into a reasonable, non-collusive post-breach settlement; the settlement established and quantified the insured's loss, detriment or damage as reflected by the presumptions that the settlement reflected the fact of its liability and that the amount was reasonable;

Point 2: The Insured's claim (or its Assignee's claim, like P's) for reimbursement of the amount of the post-breach settlement is not in the nature of a claim

[21] *Cal. Civil Code* § 953.

[22] *Cal. Civil Code* § 954.

for "indemnity," i.e., it is not a claim to collect on a judgment; hence, there is no basis upon which to apply principles of collateral estoppel—there is no judgment and no findings;

Point 3: The duty to indemnify, on the one hand, and the duty to defend, on the other, cannot be collapsed or made interchangeable; they differ in purpose; they differ in triggers; they differ in substance; and they differ in scope. Hence, there is no rational basis to apply an "indemnity" standard to a post-breach settlement. Related to this point:

a. The "purposes" are different; whereas the purpose of the duty to defend is to "avoid or at least minimize liability" *before* liability has been established, the purpose of the duty to indemnify is to "resolve liability" *after* it has been established;

b. The "triggers" are different; the duty to defend may arise as soon as damages are "sought" in some amount—the duty to indemnify can only arise after damages are "fixed" in some amount;

c. The "substance" of each is different; the duty to defend entails the rendering of a service, namely, the mounting and funding of a defense, the indemnity obligation entails the payment of money; and

d. The "scope" of each is different; the duty to indemnify may be broad but the duty to defend is perforce broader still—where there is a duty to defend, there may be a duty to indemnify; but where there is no duty to defend, there cannot be a duty to indemnify.[23]

Point 4: Having breached its duty to defend, GOT-U cannot point to any viable "Reservation of Rights," therefore, there is no basis upon which to assert grounds for non-coverage of the post-breach settlement; in effect, GOT-U cannot cloak itself with the same rights and prerogatives available to an insurer that honored its defense obligation while properly reserving rights to later dispute or disclaim coverage.[24]

[23] See, the California Supreme Court's scholarly opinion in *Certain Underwriters at Lloyd's of London v. Superior Court (Powerine),* (2001) 24 Cal. 4th 945, 951, 975, wherein each sub-part of Point 3 is set forth in greater detail.

[24] This point is discussed herein at IV.D.

2. Aside from being irrelevant, an insurer's newly discovered evidence to the effect a post-breach settlement may not be "covered" violates public policy

Through the years, in different contexts, courts have consistently rejected, as unfair and against public policy, various efforts by insurers to justify "non-coverage" results by "hindsight." In California, for example, *Mullen v. Glens Falls Ins. Co.*[25] illustrates the concept. There, an insurer refused to defend or indemnify, contending the underlying action was based on an intentional assault which was excluded from coverage. The refusal to defend was wrongful because, at the time of the refusal, there was a potential for coverage. The insured hired his own counsel; the ensuing verdict against him was based on intentional assault, thus the insurer would have been "vindicated" in its belief of non-coverage.

However, the insured was entitled to seek not only his costs of defense but also the full amount of the judgment. The court's decision was based on the notion an insurer may not deny an insured a defense at a time when it has reason to believe there is a potential for coverage and then, later, rely on the results of the lawsuit and/or subsequent factors to prove that there was in reality no potential liability in the first place. *Mullen v. Glens Falls Ins. Co.*[26] Public policy "alone" drove the ruling in *Mullen*. The court reasoned that "otherwise an insurance carrier could refuse to defend its insured on the slightest provocation and *then resort to hindsight for the justification.*"[27] The rule of *Mullen* is that the amount of judgments—including even judgments that, upon adjudication, turn out to be not covered—equate with and constitute detriment to support a damage claim for an insurer's failure or refusal to defend.

Mullen is not unique or aberrational. The purpose and rationale of other "no-justification-by-hindsight" rules have been deeply woven into the fabric of coverage law for decades. For example, in *Gray*,[28] explicit to the court's landmark decision was a rejection of the insurer's "argument that the duty to defend dissolves simply because the insured is unsuccessful in his defense and because the injured party recovers of the basis of a finding of the assured's willful conduct."[29] Hindsight was not available to the breaching insurer, Zurich Insurance Company, left pointing to an "uncovered" judgment.

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[25] 73 Cal. App. 3d 163 (1977)

[26] 73 Cal. App. 3d at 173.

[27] *Id.* at 173 (emphasis added).

[28] 65 Cal. 2d 263.

[29] *Gray* at 278.

Regarding *Gray*, it may help to pause and appreciate that the world *will never know* from the uncertain judgment in *Gray* whether, fifty plus years ago, Dr. Gray was acting "negligently" (covered) or "willfully" (not covered). It doesn't matter. The California Supreme Court removed any unfair "wait-and-see" option from Zurich, which it determined to be liable for the full amount of the judgment whether covered or not covered.

Other "no hindsight" rule formulations, are instructive. Consider the rule that a declaratory judgment of "no coverage," either by summary judgment or after trial, never retroactively relieves the insurer of the duty to defend. It only prospectively relieves the insurer of the obligation to continue to defend after the declaration. See, *Montrose Chemical Corp. v. Superior Court.*[30]

Yet another example of "no justification by hindsight" can be seen in *Haskel, Inc. v. Superior Court*.[31] There, the court held that in a declaratory relief action to determine coverage, that insurers enjoy no right to delay adjudication of their defense obligations until they can "develop" sufficient evidence through discovery to retroactively justify their earlier refusal to provide that defense.[32]

Another example of no justification by hindsight" is implicit in *Buss v. Superior Court*, ("*Buss*").[33] Recall, in a "mixed" action, in which some of the claims are at least potentially covered and others are not, the insurer has a contractual duty to defend as to claims that are at least potentially covered, having been paid premiums by the insured therefor, but does not have a contractual duty to defend as to those that are not, having not been paid therefor. The *Buss* court justified the insurer's duty to defend the entire "mixed" action prophylactically, as an obligation imposed by law:

> To defend meaningfully, the insurer must defend immediately. [citation] To defend immediately, it must defend entirely. It cannot parse the claims, dividing those that are at least potentially covered from those that are not.[34]

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[30] 6 Cal. 4th 287, 295 (1993); see also, *Buss v. Superior Court, supra,* 16 Cal. 4th at 46 ("before [being extinguished] it had a duty to defend; after, it does not have a duty to defend further").

[31] 33 Cal. App. 4th 963, 977 (1995)

[32] *Id*. at 977.

[33] 16 Cal. 4th at 48-49.

[34] *Ibid.*

Allowing non-defending insurers to look back at a post-breach settlement and demand evidence of "coverage" would contradict the reasoning and policy expressed in *Buss.*

The *Buss* court held ***defending*** insurers could seek reimbursement for defense costs provided they can be allocated solely to the claims that are not even potentially covered.[35]

The point here is that GOT-U's "*new* facts" were obtained in discovery that was *after the fact of breach* and *after the fact of settlement*. There are two principles that can be argued: First, on a basic level, post-breach settlements can never be "tested" for "coverage" because they are not judgments, hence, indemnification plays no analytical role; and second, equally important, facts newly "discovered" by insurers, are unavailable except as relevant to whether the post-breach settlement was reasonable and not collusive (and in a proceeding where such issue was raised).

B. Post-breach Judgments based on Principles of Collateral Estoppel are distinguishable from post-breach settlements

GOT-U seeks to manufacture a convenient "one-size-fits-all" rule whereby it can scrutinize P's reasonable, non-collusive post-breach *settlement* for "coverage." GOT-U may attempt to rely on certain California Supreme Court cases to support the general notion that, "like post-breach *judgments*," post-breach settlements must be "covered" by the same indemnity standard.[36]

The *rationale* of these post-breach *judgment* cases matters. *Geddes* was squarely based on established principles of ***collateral estoppel***. The very words convey, without question, the application of collateral estoppel principles. Here are the words:

> An insurer that has been notified of an action and refuses to defend on the ground that the alleges claim is not within the policy coverage is *bound* by a judgment in the action, in the absence of fraud or collusion, as to *all material findings of fact essential to the judgment of liability* of the insured. The insurer is not *bound*, however, as to issues *not necessarily adjudicated*

[35] *Id*. at 54.

[36] Cases such as *Geddes & Smith, Inc. v. St. Paul-Mercury Indemnity Co*. (1959) 51 Cal. 2d 558 ("*Geddes*") and *Hogan v. Midland National Ins. Co.* (1970) 3 Cal. 3d 553 ("*Hogan*")

> *in the prior action* and can still present any defenses not inconsistent with the judgment against the insured. [37]

The court in *Geddes* cited and relied upon the Restatement of Judgments, § 107a, pp. 513-518.[38] By 1959, when *Geddes* was published, collateral estoppel had been well-established in California jurisprudence.

In *Bernhard v. Bank of America*[39] the Supreme Court pointed out that the doctrine of res judicata not only bars re-litigation of the same cause of action once a final determination has been made by a court of competent jurisdiction, it also precludes a reexamination as between the parties or their privies of any ***issue*** necessarily decided if the issue is involved in any subsequent lawsuit brought on a different cause of action. [40]

Thus, in *Geddes*, the high court faithfully applied collateral estoppel principles and ruled that in a suit on a judgment to enforce the policy an insurer may or may not be "bound" by a judgment depending on whether coverage issues were litigated to finality.[41] The reasoning in *Geddes* does not extend to settlements.

Geddes was followed by *Hogan* in 1970 which *also* applied collateral estoppel principles. Factually, *Hogan* involved a "mixed" or "severable" judgment. The resolution of factual matters in the underlying action allowed the court to determine that some damages were covered and some were not.

P would do well to observe four (4) common threads that run through *Geddes* and *Hogan*:

(1) In each case there was a breach of the duty to defend;

(2) In each case the insured provided for his own defense;

(3) In each case there was a post-breach judgment which included factual findings that either did, or did not, permit the court to apply collateral estoppel principles so as to "bind," or not, the insurer; and

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[37] *Geddes, supra,* 51 Cal. 2d. at 561.

[38] *Id.,* at 562.

[39] 19 Cal.2d 807 (1942)

[40] *Id.,* at 810.

[41] See, *Geddes, supra,* 51 Cal. 2d at 561.

(4) In each case the claim was for indemnity "on" a judgment to enforce a policy's terms and provisions.[42]

Hogan was no different.

> [O]ne of the consequences of an insurer's failure to defend is that it may be bound, in a subsequent suit to enforce the policy (or in a direct action under Ins. Code §11580), by the express or implied resolution in the underlying action of the factual matters upon which coverage turns.[43]

As seen, the rule of *Geddes* and *Hogan* is squarely based on principles of collateral estoppel. Those principles *only* apply to indemnity claims on a judgment or direct statutory actions on a judgment for indemnity coverage.

The collateral estoppel rule applicable to certain post-breach *judgment*s, exemplified by *Geddes* and *Hogan*, cannot be "crazy glued" to post-breach *settlements* or even to *all* post-breach judgments.

The seminal case of *Gray v. Zurich Ins. Co.*[44] is instructive here. The suit Zurich *should* have defended arose out of an altercation between Dr. Gray and Mr. Jones. Jones sued in Missouri aggressively alleging an assault, seeking both actual and punitive damages.[45] Zurich refused to defend on the ground the complaint alleged an intentional tort which fell outside the coverage of the policy. *Id*. Dr. Gray thereafter unsuccessfully defended on the theory of self-defense; he suffered a judgment of $6,000 actual damages although no punitive damages were awarded. *Id.*

Gray sued Zurich for *damages* for failure to defend. *Id.*, at 267. Zurich's defenses included that "the judgment in the third-party suit upholding the claim of an intentional bodily injury operates to [collaterally] 'estop' the insured from recovery."[46]

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[42] Regarding the *last* point, the claim in *Geddes* was for *indemnity.* The first sentence says so: "Plaintiff appeals from a judgment for defendant *in an action to recover on an insurance policy* issued by defendant to [insured]." *Geddes, supra,* 51 Cal.2d at 561. Thus, the court had to compare the material findings essential to the judgment with the terms and conditions of an insurance policy.

[43] *Pruyn v. Agricultural Ins. Co.,* 36 Cal. App. 4th 500, 514 n. 15 (1995) (J. Croskey's characterization of *Hogan.*)

[44] *Gray, supra,* 65 Cal. 2d 263.

[45] *Id*., at 267.

[46] *Id*. at 269. In *Gray*, the "judgment" in the underlying case was ***not clear.*** That's an understatement. The record on appeal included a mishmash of Dr. Gray's offer of proof (rejected by the trial court), exhibits introduced at trial

The court rejected Zurich's argument that if the judgment in a third-party suit goes against the insured it operates as "res judicata or collateral estoppel in the insured's action or proceeding against the insurer."[47]

Gray stands for the proposition that ". . . the insurer [who wrongfully fails to defend] is liable [for the amount of the judgment against its insured] whenever the trial in the underlying action involved a theory of recovery within the coverage of the policy and it was not clear whether the jury's verdict was based upon that theory."[48]

Why did the court in *Gray* determine that an "unclear," post-breach judgment was not susceptible to collateral estoppel? For one thing, an "unclear" judgment from which no one can intuit whether Dr. Gray was negligent (covered) or acting intentionally (not covered) could not "bind" the insurer under collateral estoppel principles. However, that was not the end the analysis. Based on *public policy*, the non-defending insurer, Zurich, was held liable for the amount of the unclear, post-breach judgment because it had subjected or exposed its own insured to the risk of that adverse judgment. The court reasoned: "If he [the insured] is to be required to finance his own defense and then, only if successful, hold the insurer to its promise by means of a second suit for reimbursement, we defeat the basic reason for the purchase of the insurance."[49]

Recall, the four (4) suggested threads running through the G*eddes/Hogan* rule. Applying those to *Gray*, while there ***was*** a breach of the defense obligation and while Dr. Gray ***did*** provide for his own defense, there were ***no factual findings*** in the judgment clear enough to "bind" the insurer; *and*, Dr. Gray's claim was ***not for indemnity*** "on" the judgment in any event. Dr. Gray's claim was for damages.

Similarly, in *Mullen v. Glens Falls Ins.* Co.,[50] the insurer wrongfully refused to defend or indemnify even though at the time of the refusal it was aware of facts giving rise to the potential for coverage. The insurer was not permitted to point to the "uncovered" judgment in the third party's action against the insured to show the absence of actual or

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consisting of pleadings and the verdict in the Missouri suit and a copy of the subject insurance policy. The parties waived findings of fact and conclusions of law. *Id.* at 267.

[47] *Id.* at 278.

[48] See, e.g., *Hogan v. Midland Nat. Ins. Co., supra,* 3 Cal. 3d at 566; also, *Pruyn v. Agricultural Ins. Co., supra,* 36 Cal. App. 4th at 514, n. 15.

[49] *Gray, supra,* 65 Cal. 2d at 278.

[50] 73 Cal. App. 3d 163 (1977).

potential coverage.[51] Again, as *Mullen* illustrates, an "uncovered" judgment was deemed not susceptible to collateral estoppel based on *public policy*.

Amato v. Mercury Casualty Co.[52] ("*Amato*") followed the holding in *Mullen*. *See, Amato,* at 832. It also followed *Gray. Amato,* at 833.

In *Amato* a post-breach judgment was clearly uncovered because the jury found by special verdict that Ms. Sutton did reside with Mr. Amato; hence, the "Resident Relative Exclusion" would have negated coverage. See, *Id.* at 830 (re the special verdict) and at 837 (re the exclusion). However, that was not the result. In *Amato* the appellate court found the insurer liable for the full amount of the uncovered judgment. The court drew a clear and powerful distinction between Mr. Amato's claim for breach of the defense duty, on the one hand, and Ms. Sutton's direct-action claim for coverage under *California Ins. Code* §11580, on the other. Recall, the court's teaching:

It may seem 'quixotic' that Sutton is denied recovery on her direct action on the policy but Amato is entitled to recover for Mercury's failure to defend. However, the distinction is explainable by the ***difference in nature of their respective claims***. Sutton's claim depends on the contract terms of the coverage provisions of the insurance policy, whereas Amato's claim is based on the judicially expanded duty to defend. It is well established in California that 'an insurer that wrongfully refuses to defend is liable on the judgment.[53]

Recall, again, the four (4) threads running through *Geddes/Hogan.* In a post-breach *settlement* situation, the "third" and "fourth" threads are always absent. There is neither a judgment nor any "factual findings" upon which collateral estoppel might be based, not even theoretically. Also, and importantly, the nature of a post-breach settlement claim is never for "indemnity." It never seeks payment "on" a judgment and it is never a direct action under §11580. It is always a claim for damages based on the judicially expanded defense obligation.

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[51] See, *Mullen v. Glens Falls Ins. Co., supra,* 73 Cal. App. 3d at 173-174 (explaining that ". . . a contrary holding 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. . . [T]his could deprive [the insured] of the expertise and resources available to the carriers in making prompt and competent investigations as to the merits of lawsuits filed against their insureds"). The echo of *Gray* is unmistakable.

[52] , 53 Cal. App. 4th 825 (1997)

[53] See, *Amato v. Mercury Cas. Co., supra,* 53 Cal. App. 4th at 839 (emphasis added).

C. Permitting GOT-U to Challenge "Coverage" with respect to a post-breach settlement ignores that GOT-U breached an implied-in-law duty to ***also*** defend those claims that were not potentially covered

Virtually all courts agree that in a "mixed" action, that is, an action that contains claims that are at least potentially covered along with claims that are not, the insurer must defend the entire action.[54] In such a mixed action, the insurer has a contractual duty to defend as to claims that are at least potentially covered, having been paid premiums by the insured therefor, but does not have a contractual duty to defend as to those that are not, having not been paid therefor.

In *Buss v. Superior Court*,[55] the California Supreme Court ruled that in a "mixed" action, in which some of the claims are at least potentially covered and others are not, there is a *contractual* duty to defend the claims at least potentially covered and an *implied-in-law* duty to defend, prophylactically, claims that are not. [56]

It follows that where an insurer fails or refuses to defend a "mixed" action, it necessarily breaches two (2) separate and distinct defense obligations. In the hypothetical, D, the abandoned insured, was not only exposed to claims that were at least potentially covered but also to claims that were not.

Post-breach settlements obviously resolve *all* claims, potentially covered and otherwise. GOT-U would have no reason based in logic or the law why it must be allowed to locate a covered "pearl" that may, or may not be buried in "mixed" sands. The damage to D, the insured, is the amount fixed by a reasonable post-breach settlement—not simply the amount, if any, that might be allocated to a "portion" of D's detriment.

It bears mention that a *pointless* search for the "covered" pearl in mixed sands would also be impossible in any event. GOT-U seeks to impose on courts and litigants two (2) separate tasks: First, trying to identify or reconstruct which alleged facts supported claims that were potentially covered, and Second, trying to determine whether these alleged facts might have been proven, had the insurer not breached.

The search is not only pointless—it's unfair. GOT-U, in breach, should not be allowed to divert money otherwise available for defense of D into a convenient war chest with which to defeat P's (assigned) claims for reimbursement. Also, GOT-U should not be

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[54] RLLI, §14, Reporter's Note, b. *The duty to defend the whole action.*

[55] 16 Cal. 4th 35 (1997)

[56] *Id.,* 48-51.

allowed to use post-breach "discovery" to garner hindsight evidence regarding "non-coverage" of the post-breach settlement, as discussed above.

The court in *Buss* justified the insurer's duty to defend the entire "mixed" action prophylactically, as an obligation imposed by law:

> To defend meaningfully, the insurer must defend immediately. [citation] To defend immediately, it must defend entirely. It cannot parse the claims, dividing those that are at least potentially covered from those that are not.[57]

At the heart of the *Buss* decision is the concept that ***by defending*** the entire "mixed" action, as they are obligated in law to do, insurers were entitled to look back retroactively for allocation and reimbursement. It is hard to imagine the California Supreme Court, applying the logic of *Buss*, would tolerate a rule whereby GOT-U, a ***non-defending*** insurer would be permitted to look back at a post-breach settlement and demand evidence of "coverage."[58] The "look back" prerogative whereby insurers can seek reimbursement for settlements always presumes and is conditioned upon there having been no antecedent breach of the defense obligation.

D. GOT-U failed to defend; thus, it had no viable "Reservation of Rights" with which to later disclaim coverage even in the event of an adverse judgment against D; in the context of a post-breach *settlement,* GOT-U has no greater rights

Recall, GOT-U did not defend. It follows that GOT-U did not (and could not) "reserve" any rights to dispute or disclaim coverage even in the event of an adverse judgment against D. In the context of a post-breach settlement, setting aside that "coverage" is irrelevant, GOT-U's position seems even less tenable.

If a liability insurer's reservation of rights is to have any useful meaning, it must be in the context of its performance of its duty to defend or settle. It is universally understood that an insurer may accept defense of a lawsuit without raising any objection to coverage, but, by so doing, it waives its right to contest coverage at a later date.[59] In most jurisdictions, a

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[57] *Buss v. Superior Court, supra,* 16 Cal. 4th at 49, 939 P.2d at 775.

[58] The same observation could be made about yet another Supreme Court case, *Johansen c. Calif. State Auto. Assn. Inter-Ins. Bur*., 15 Cal. 3d 9, 19 (1975) (stating that "if, having reserved its right to assert a defense of non-coverage and having accepted a reasonable [settlement] offer, the insurer subsequently established the non-coverage of its policy, it would be free to seek reimbursement of the settlement payment from its insured").

[59] *Truck Ins. Exchange v. Superior Court,* 51 Cal.App.4th 985, 993; 59 Cal.Rptr. 2d 529 (1996).

wrongfully non-defending insurer that purports to issue a reservation of rights is be deemed to have waived its "reserved" defenses to coverage.[60] The implied or deemed waiver rule discourages insurers who defend without reserving rights. They pose a potential risk of unfair prejudice to the insured who may be denied the right to protect its coverage interests.[61]

It's worth mentioning, Washington takes no back seat when it comes to strong pronouncements:

> We therefore hold that when an insurer wrongfully refuses to defend, it has voluntarily forfeited its ability to protect itself against an unfavorable settlement, unless the settlement is the product of fraud or collusion.[62]

The California Supreme court in two landmark cases provides that an insurer's defense under reservation of rights preserves an insurer's "due process" rights to later contest both its defense obligation and allows it, in the proper circumstances, to contest its settlement obligations.[63]

A rule allowing a wrongfully non-defending insurer to attempt to allocate a settlement (or judgments) discourages insurers from defending under reservation of rights. The liability insurer's reservation of rights exists to protect both the insurer and the insured by allowing an insurer who is under of its obligations under the policy to undertake a defense while reserving its rights to ultimately deny coverage.[64]

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[60] See RLLI, §15, Reporter's Note a ("Although the requirement that the insurer must reserve its rights was originally grounded in estoppel, 'a review of the case law reveals it has since developed into a distinct doctrine that stands on its own.'" [citations omitted]); see also, Couch on Insurance, Third Edition, §239:107 ("It must be generally be shown by the party claim a waiver that the person against whom the waiver is asserted had, at the time, knowledge, actual or constructive, of the existence of his or her rights or all the material facts upon which they depended, and the same requirement applies to equitable estoppel").

[61] See RLLI, §15, Comment a; but see, *Standard Mut. Ins. Co. v. Lay*, 989 N.E.2d 591 (Ill. 2003) (rejecting "presumed prejudice" and requiring proof of prejudice to the insured).

[62] Thus stated the Supreme Court of Washington in *Truck Ins. Exchange v. VanPort Homes, Inc.* 147 Wash. 2d 751, 765-6 (2002).

[63] See, *Buss v. Superior Court (Transamerica Ins. Co.),* 16 Cal.4th 35 (1997) (preserving equitable right of defending insurer under reservation of rights to seek reimbursement of defense fees for clearly uncovered claims in mixed actions); *Blue Ridge Ins. Co. v. Jacoobsen*, 25 Cal. 4th 489 (2001) (preserving the equitable right of a settling insurer under reservation of rights to seek reimbursement of uncovered settlement amounts from the insured).

[64] *R.T. Vanderbilt Company, Inc. v. Hartford Accident & Indemnity Co.,* 156 A.3d 539, 621 (Conn.App. 2017).

V. Conclusion

As Insurers have known for decades, there are risks or perils to breaching the defense obligation. This paper addresses ***one*** such peril—perhaps the greatest peril in actual fact.

The thesis here is that upon breach, the insured has the right to enter into a reasonable and non-collusive settlement. The settlement creates presumptions of the insured's liability-in-fact and the amount thereof. The post-breach settlement should not be challenged on the basis it is not "covered" for the many compelling reasons explained above. The post-breach settlement established and quantified the insured's damages—period, full stop to the analysis.

That the insured's post-breach settlement included an assignment of all assignable at law claims against the insurer in consideration of a limited recourse provision or covenant not to execute is of no consequence. This is so because the assignment was not a "gift" to the third party claimant—it was a necessary transfer of property to resolve the dispute.

Insurers can and should self-protect by defending with reservations of rights. By so doing they will not be estopped from later disputing coverage in the event of an adverse judgment nor can they be deemed to have waived any right to do so.

Finally, recognizing that post-breach settlements need not be established as "covered" is fair and just. The judicial system can ill-afford countless "second suits" by insureds or their assignees wherein and whereby they are forced to prove an irrelevant or perhaps even impossible thing, namely, that a post-breach settlement is "covered." Insurers should not deprive their insureds of defenses which were contractually promised—nor should they use money "saved" as convenient war chests to defeat the pointless second suits. Finally, universal recognition of the "peril" of post-breach settlements will provide an appropriate incentive against breaches of the duty to defend.

AFTERWORD

The well-articulated issues and researched positions presented in the substantive paper are (mostly) presented from the policyholder perspective. The insurer side of these same issues, in and out of California, undeniably comes to very different conclusions on the public policy and legal premises presented. We leave the reader with certain comments and ideas for thought to aid a hopefully robust discussion at the May meeting.

The duty to defend and the duty to indemnify are separate obligations evaluated under different standards.[65] While a defense is owed for a claim potentially covered based on the allegations asserted, the duty to indemnify is a separate contractual obligation based on the actual facts. Under the hypothetical proposed, the assignee claimant stands in the shoes of the insured and is therefore entitled, under a breach of contract theory, to no greater coverage than the insured would have been entitled to receive. And, at least under some states' laws, "even if a liability insurer breaches its duty to defend, the party seeking indemnity still bears the burden to prove coverage if the insurer contests it."[66] Said differently, the doctrines of waiver and estoppel cannot be used to create insurance coverage where none exists under the terms of the policy. [67]

The *Pruyn* case cited in the paper does not say that an insurer must pay for non-covered damages. Rather it says that the insurer should pay for amounts that "cannot be attributed to uncovered claims." [68] Moreover, while settlement reached without the insurance carrier's consent may create a presumption of the insured's underlying *liability* in a situation in which the insurer breached its duty to defend, this presumption does not address whether such liability is for a covered event. California precedent, starting with *Lamb v. Belt Cas. Co.*,[69] has required proof of coverage for settled damages. [70]

Upon proof of a breach of the duty to defend, the insured or assignee is entitled to damages including defense costs but may not be entitled to the policy limit or amount of stipulated judgment unless there is first proof that the judgment is for a covered claim.[71] Of course, in California those costs may include the costs of *Cumis* counsel, the amount of the settlement for which there is coverage for such damage under the terms of the policy and

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[65] *See King v. Dallas Fire Ins. Co*., 85 S.W.3d 185, 187 (Tex. 2002); *Trinity Univ. Ins. Co. v Cowan*, 945 S.W.2d 819, 821 (Tex. 1997).

[66] *Utica Nat. Ins. Co. v. American Indem. Co*., 141 S.W.3d 198 (Tex. 2004).

[67] *See, e.g., Texas Farmers Ins. Co. v. McGuire*, 744 S.W.2d 601, 602-03 (Tex. 1998).

[68] *Pruyn v. Agric. Ins. Co*., 36 Cal.App.4th 500, 42 Cal.Rptr.2d 295, 303 (1995), citing *Samson v. Transamerica Ins. Co*., 30 Cal.3d 220, 178 Cal.Rptr. 343, 636 P.2d 32, 44 (1981).

[69] 3 Cal.App.2d 624, 40 P.2d 311 (Cal. Ct. App. 1935)

[70] *See, e.g., Hogan v. Midland Nat'l Ins. Co.*, 3 Cal.3d 553, 476 P.2d 825 (Cal. 1970) and *Geddes & Smith, Inc. v. St. Paul Mercury Indem. Co.*, 51 Cal.2d 558, 561-62, 334 P.2d 881 (Cal. 1959). *See also Pruyn v. Agric. Ins. Co.*, 36 Cal.App.4th 500, 527-28, 42 Cal.Rptr.2d 295, 312 (Ct. App. 1995); *Xebec Dev. Partners, Ltd. v. National Union Fire Ins. Co.*, 12 Cal.App.4th 501, 545, 15 Cal.Rptr.2d 726, 749 (Ct. App. 1993), *disapproved on other grounds by Essex Ins. Co. v. Five Star Dye House, Inc.*, 38 Cal.4th 1252, 1265 n. 4, 137 P.2d 192, 199 n. 4, 45 Cal.Rptr.2d 362, 371 n. 4 (Cal. 2006).

[71] *See Pruyn*, 36 Cal.App.4th at 513, 42 Cal.Rptr.2d at 302.

interest. In Texas, the insured would be entitled to defense costs plus statutory penalties of 18 percent per annum for unpaid defense costs, plus interest for a breach of contract.[72]

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[72] *See* Tex. Ins. Code §542.060.