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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Calif. Must Clarify Independent Counsel Rates For Insurers

By **Christine Haskett, Ryan Buschell and Michael Lanosa** (June 29, 2020, 4:02 PM EDT)


Christine Haskett


Ryan Buschell


Michael Lanosa

Sometimes, insurance defense counsel will face a conflict of interest between the duties owed to his or her dual clients: the insurance company and the insured.

The California Court of Appeal addressed this issue in San Diego Navy Federal Credit Union v. Cumis Insurance Society Inc. and held that when such a conflict exists, the insured is entitled to retain independent defense counsel, not controlled by the insurance company. But in the face of insurer complaints about the expense of so-called Cumis counsel, the California Legislature codified and limited the Cumis rule in California Civil Code Section 2860.

Enacted 33 years ago, Section 2860 sets forth the rules that govern when an insured is entitled to independent defense counsel, and the qualifications that Cumis counsel must have. The subject of this article, however, is another part of Section 2860, which seeks to address a frequent dispute between insurers and policyholders: the hourly rates that an insurer is required to pay independent counsel so selected.

Unfortunately, over 30 years after its passage, Section 2860 has brought little predictability to the hourly rates policyholders can expect to be reimbursed in many cases. This article examines several problems with Section 2860's hourly rate provision and proposes some potential solutions.

The Right to and Reimbursement of Independent Counsel

Third-party liability insurance policies typically include a duty-to-defend provision requiring insurers to defend their insureds against lawsuits that may trigger the policy's coverage. A restaurant that purchased commercial general liability insurance and then is sued by a patron injured on its premises as a result of slipping on a wet floor, for example, is not left to defend the lawsuit on its own.

By purchasing insurance coverage, the restaurant bargained to receive a legal defense to the lawsuit as well as coverage for its potential liability. In exchange for this defense, however, insureds forfeit much of the control over their legal representation that they would have had otherwise.

When an insurer recognizes coverage under a duty-to-defend policy, standard-form policy language permits the insurer to select defense counsel and then to control the defense essentially as if it were the party to the lawsuit. While the insured remains the defendant, it is the insurance company that directs legal strategy, decides whether to litigate or settle the claim, and ultimately pays any resulting liability out of the policy's limits.

But this state of affairs is not set in stone. In California, as in virtually all jurisdictions, the duty to defend is broader than the duty to indemnify.[2] It is thus common for an insurer to recognize that some facts alleged in the underlying lawsuit implicate a potential for coverage — thus triggering the policy's duty to defend — but that other allegations, if proven true, could render the claim uncovered.

For example, the restaurant patron may allege both that the wet floor that caused the injury was a result of the restaurant's negligence (a covered claim) and, in the alternative, that the wet floor was the result of some intentional conduct, which generally would not be covered by insurance. In that circumstance, the insurer must provide a defense but may reserve its right to deny coverage should the insured be held liable for intentional conduct.

Such reservations of rights have consequences for the defense of the underlying action, as they often create an unresolvable conflict of interest. In such cases, insurer-retained counsel defending the patron's lawsuit can be placed in the untenable position of making strategy and litigation decisions in defense of the lawsuit that could have an impact on the later coverage dispute between insurer and insured.

California law (as recognized in the Cumis decision) therefore provides that the insured in this type of case has the right to retain independent counsel of its choice and to control its own defense, and that the insurer "must pay the reasonable cost for hiring independent counsel [selected] by the insured."[3]

A frequent dispute that arises in connection with the retention of independent counsel involves the hourly rates the insurer must reimburse. Such disputes are particularly likely to occur when the scope, complexity or subject matter of the underlying lawsuit calls for highly specialized defense counsel or greater than usual law firm resources.

The more specific or complicated a practice area, the more likely it is that experts in the field will command high hourly rates. But insurers are especially reticent to pay counsel's full hourly rates when a policyholder needs specialized defense counsel because:

- The hourly rates that more specialized counsel from large law firms command are substantially higher than the deeply discounted rates that insurers — who are volume consumers of legal services — are able to obtain for more routine cases; and

- An insurer's payment of defense costs often does not erode a policy's limit of liability, and insurance companies therefore have an economic incentive to maintain low hourly rates across their hundreds or thousands of cases, even if defense counsel are less suited for certain high-stakes and complicated cases and thus may yield — on average — worse results for insureds.

California Civil Code Section 2860 and the Similar Action Requirement

In 1987, the California Legislature passed Civil Code Section 2860, which provided a new framework for resolving disputes over the hourly rates an insurer is required to pay for independent counsel. Generally seen as a victory for the insurance industry, Section 2860(c) permits insurers to limit the rates for independent counsel "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 [third-party] claim arose or is being defended."[4]

To the extent that the insurer and insured cannot agree on an hourly rate (and if no other means of resolution is contained in the policy), Section 2860(c) provides that any dispute concerning attorneys fees "shall be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute."[5]

Much has been written about the haphazard and rushed drafting of Section 2860.[6] As drafted, however, the requirements of the statute are simple enough to apply to the run-of-the-mill legal disputes that form the bulk of insurers' litigation portfolios. Thousands of substantively similar lawsuits involving auto accidents and bodily injury claims are litigated and resolved across the country every year.

There will likely be a number of such cases recently defended by the insurer in the jurisdictions where it issues policies, and so the hourly rates that an insurance company pays insurer-retained counsel in those actions will be straightforward to identify and apply under Section 2860.

The consequences of Section 2860's hurried drafting process, however, are painfully apparent when insurers and insureds attempt to apply the provision to the types of cases in which hourly rate disputes are most likely to occur — i.e., high-stakes or bet-the-company actions presenting unique or specialized legal and factual issues. The language of Section 2860 provides three major hurdles to resolving hourly rate disputes that arise in these types of lawsuits.

First, high-stakes actions raising specialized or unique legal and factual issues are by definition uncommon. Consequently, arbitrators adjudicating hourly rate disputes around these cases often will find that the insurer has never defended a similar action in the same community. Section 2860 does not explain how the arbitrator should resolve the dispute in this circumstance.

In the absence of a similar action, insurers have argued that the provision's language requires the arbitrator to apply the hourly rates paid by the insurer in what the insurer contends is the most similar action, even when no reasonable observer would characterize the cases as similar.

Second, the drafters of Section 2860 exchanged clarity for brevity by providing no definitions of important terms in the statute. Arbitrators are provided no guidance on what metrics they should use to measure similarity (complexity, subject matter, required expertise, potential exposure, etc.) or on how similar two actions must be to trigger the hourly rate limitation.

Likewise, arbitrators are provided no direction as to how to define the relevant community or how to deal with a similar action that arose in one jurisdiction but is being defended in another.

Third, the first two problems are exacerbated by Section 2860's mandatory arbitration provision. While the intention to provide for less expensive and streamlined dispute resolution can be appreciated in the abstract by both insurers and insureds, the prohibition against resolving hourly rate disputes in court means there is no body of case law that might have ironed out the statute's ambiguities.

Insureds' reimbursement for their independent counsel is thus left to each arbitrator's predilections regarding how similar one action must be to another in order to trigger the hourly rate limitation and what to do when the insurer has never before defended an action in the relevant community. Section 2860's mandatory arbitration provision has ensured that its language is no more clear today than it was upon its enactment 33 years ago.

Proposals to Improve Section 2860

Having recognized some of the problems with the text of Section 2860(c) as written, the question of course is how to fix them.

As noted above, one of the main issues left unaddressed by the express language of the statute is how the parties are to proceed in the event that the insurer has never before defended an action similar to the action at issue. Any solution to this shortcoming must recognize that the similarity requirement of Section 2860(c) was essentially designed to provide an insurer with an affirmative defense in the face of an insured's insistence that the insurer pay rates higher than those deemed reasonable in the legal market.

As the Cumis court expressly held, when a conflict of interest requires the appointment of independent counsel, "the insurer must pay the reasonable cost for hiring independent counsel by the insured."[7] Section 2860(c) provides an insurer with statutory support for an argument that rates higher than those the insurer pays in similar cases are per se unreasonable.

If there are no similar cases, however, then this defense simply should be inapplicable. In other words, if the insurer cannot prove that there are similar cases in the same community for which it pays less than the hourly rate charged by independent counsel in the case at issue, then the arbitrator must award the policyholder the reasonable hourly rate for its independent counsel as articulated in Cumis.

Given the holding of Cumis, this should be the correct outcome without the need for any modifications to the language of Section 2860(c). As discussed above, however, insurers in Section 2860 arbitrations often argue that in the absence of a similar case, the most similar case must be used as a reference, notwithstanding that the cases often will have many more differences than similarities.

Clarification of the statute — and providing a default to the reasonableness standard endorsed by Cumis in the absence of a similar action — would avoid the illogical consequences of these types of arguments.

Separately, disputes under Section 2860(c) would be greatly simplified and streamlined if the statute were to provide guidance as to the meanings of the words "similar" and "community."

First, with regard to "similar," is the proper inquiry whether another case is factually similar? Similar in scope and complexity? Similar in legal practice area? To avoid needless disputes over these issues, we would recommend a definition along the lines of: "similar in subject matter, complexity, and potential liability such that a reasonable litigant would hire attorneys with the same or similar expertise, skill, and resources to represent it in the action."

This avoids the problem of insurers arguing, for example, that all product liability cases are similar even when one involves a run-of-the-mill dispute and the other is complicated bet-the-company type of case.

Finally, Section 2860(c) would be greatly improved by what would amount to only a minor clarification of the community requirement. Where a claim arose, or even where it is being defended, often has little to do with the hourly rates of attorneys required to defend an action.

For example, a claim might arise from an injury sustained in City X, but the lawsuit may be brought in City Y. And in the context of complicated, high-stakes cases — which are often defended by attorneys with national practices — it is not uncommon for the lawsuit pending in City Y to be defended by attorneys from City Z.

The fact that City X has a lower market rate for legal services is of no help to an insured who must litigate in City Y, regardless of where the injury was sustained. And the fact that City Y has a lower market rate than City Z is likewise irrelevant if City Z lawyers are what is needed to defend the claim.

Tying hourly rates to the location where the claim arose or is being defended is therefore especially inappropriate when Section 2860 is applied to these types of cases. Accordingly, the statute should be clarified to explain that, once another action pending in the same community has been deemed similar, what is important is what hourly rates are being charged in that case, regardless of where the attorneys reside or where the claim arose.

And again, if there is no similar case in the same community, as discussed above, the inquiry should revert to the reasonableness standard set forth in Cumis.

Conclusion

In conclusion, we propose revising Section 2860 to clarify that when the insurer has not paid to defend any cases in the same community that are similar to the insured's case, Section 2860(c) does not apply. In addition, the statute should clarify the factors to be considered in determining when two cases are similar, and how to apply the community requirement.

We believe these changes will provide much-needed guidance for resolving disputes between insurers and insureds over the hourly rates an insurer is obligated to pay for independent defense counsel selected by the insured, particularly when the characteristics of the underlying lawsuit make it readily distinguishable from the run-of-the-mill cases that make up the bulk of the insurer's litigation defense portfolio.

Christine Haskett is a partner, Ryan Buschell is special counsel and Michael Lanosa is an associate at Covington & Burling LLP.

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[1] San Diego Navy Fed. Credit Union v. Cumis Insurance Society Inc. , 162 Cal. App. 3d 358 (1984).

[2] See, e.g., Montrose Chem. Corp. v. Super. Ct. , 6 Cal. 4th 287, 295 (Cal. 1993)

[3] San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc., 162 Cal. App. 3d 358, 375 (1984).

[4] Cal. Civ. Code § 2860(c).

[5] Id.

[6] See, e.g., Rich Marotti, Reconstructing Cumis: What the California Legislature Got Wrong about California Civil Code Section 2860 and How to Fix It, 60 Hastings L.J. 881, 887-88 (2009); E. Gerard Mannion and Wesley Lowe, Debunking the Cumis Counsel Myths, Plaintiff Magazine, June 2013, at 3 n.1. available at https://www.plaintiffmagazine.com/images/issues/2013/06-june/reprints/Mannion-and-Lowe_Debunking-the-Cumis-counsel-myths_Plaintiff-magazine.pdf ("Civil Code §2860 was one of the progeny of the infamous 'napkin deal' which was an agreement that was struck (and memorialized on a napkin) between [the California Trial Lawyers Association, now known as the Consumer Attorneys of California] and … business interests in order to head off an initiative fight").

[7] Cumis, 162 Cal. App. 3d at 375 (1984) (emphasis added).
