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"DUTY TO DEFEND" DENIALS REQUIRE A SECOND LOOK

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Untold millions of dollars are left on the table by policyholders who fail to challenge wrongful coverage denials. This article aims to remind business litigators of their clients' rights under any liability policy—be it a Directors & Officers, Professional Liability, Employers Practices Liability, or Commercial General Liability policy—which includes a "duty to defend."

A. The "Potential for Coverage" Standard

The California Supreme Court has made clear that a liability insurer owes a duty to defend unless an underlying lawsuit against its insured can "by no conceivable theory" raise a "single issue" within the policy coverage. *See Montrose Chem. Corp. v. Superior Court*, 6 Cal.4th 287, 300 (1993) (quoting *Gray v. Zurich Ins. Co.*, 65 Cal.2d 263, 276 n.15 (1966)).

Importantly, the California Supreme Court has emphasized that the duty to defend turns on the potential for coverage raised by the "facts" alleged, and not on the formal causes of action pleaded in the complaint. *See Scottsdale Ins. Co. v. MV Transp.*, 36 Cal.4th 643, 654 (2005); s*ee also Pension Tr. Fund for Operating Eng'rs v. Fed. Ins. Co.*, 307 F.3d 944, 951 (9th Cir. 2002) (explaining "remote facts buried within causes of action that may potentially give rise to coverage are sufficient to invoke the defense duty").

Even facts which are extrinsic to a complaint (e.g., facts in pre-suit communications, interrogatory responses, depositions, and expert reports) can trigger the duty to defend if known to the insurer. *See Montrose*, 36 Cal.4th at 296; *see also Am. Guarantee & Liab. Ins. Co. v. Vista Med. Supply,* 699 F.Supp. 787, 794 (N.D. Cal. 1988) (finding duty to defend premised on a declaration made by plaintiff in underlying action).

B. Application to Business Litigation

This broad "potential" for coverage standard is routinely applied by California's courts to hold liability insurers in breach of their duty to defend insureds in business litigation. *See, e.g.*, *CNA Cas. of Cal. v. Seaboard Sur. Co.*, 176 Cal. App.3d 598, 608 (1986) (finding factual allegations in support of uncovered "antitrust" cause of action implicated potential coverage for piracy, unfair competition and idea misappropriation); *Pension Tr. Fund*, 307 F.3d at 954 (concluding facts alleged in support of cause of action for "lender liability" could support a finding of coverage for breach of fiduciary duty); *Hudson Ins. Co. v. Colony Ins. Co.*, 624 F.3d 1264, 1268 (9th Cir. 2010) ("It does not matter that the NFL complaint . . . never listed slogan infringement as a cause of action."); *KM Strategic Mgmt. LLC v. Am. Cas. Co. of Reading PA*, 156 F.Supp.3d 1154, 1160–61 (C.D. Cal. 2015) (finding a "particular paragraph" in the underlying complaint created potential coverage for defamation despite the absence of causes of action for slander or libel).

Evaluating whether the duty to defend is triggered requires a liability insurer to conduct a rigorous investigation, filtering every factual allegation through the policy's myriad coverage grants to identify any potential for covered liability. It is not surprising, particularly in complex business litigation, that insurers often get it wrong.

When a wrongful denial goes unchallenged, the insurer incurs no penalty whatsoever—to the contrary, it profits. Meanwhile, the policyholder is left without the insurance protection it paid for, at times with devastating consequences.

C. Statute of Limitations

The limitation period for breach of the duty to defend is four years. *See* Cal. Code Civ. Proc. § 337. Recognizing the importance of the duty to defend, as well as its continuing nature, the California Supreme Court has held that this limitation period is subject to equitable tolling. *See Lambert v. Commonwealth Land Title Ins. Co.*, 53 Cal.3d 1072, 1079–80 (1991). Specifically, even though the action against the insurer accrues upon the refusal to defend, the limitation period is tolled until resolution of the underlying action. *Id*. at 1080.

This tolling rule has also been applied to a claim that the insurer's wrongful denial breached its implied covenant of good faith and fair dealing. *See McGranahan v. Ins. Corp. of N.Y.*, 544 F.Supp.2d 1052, 1063 (E.D. Cal. 2008) (finding "that the two-year statute of limitations for [the insured's] claim for bad faith and fair dealing was equitably tolled until entry of final judgment").

D. Damages for Breach of the Duty to Defend

The potential damages recoverable for breach of the duty to defend include the defense fees and costs incurred, "bad faith" damages, and punitive damages. While beyond the scope of this article, the insured may also be able to recover from its insurer the amount of any settlement it reached or judgment it paid.

1. Defense Fees and Costs

Where an insurer breaches its duty to defend, "the proper measure of damages is the reasonable attorneys' fees and costs incurred by the insured in defense of the claim." *Marie Y. v. Gen. Star Indem. Co*., 110 Cal.App.4th 928, 960–61 (2003).

An insured should also be able to recover prejudgment interest at the annual rate of 10% from the date of each invoice. *See* Cal. Civ. Code § 3289(b); *Tradewind Prods., Inc. v. Hartford Fire Ins. Co.*, No. 06-5201, 2009 WL 10710831, at *4 (C.D. Cal. Mar. 30, 2009) ("[P]laintiff is entitled to prejudgment interest from the dates it received invoices from its attorneys until defendants tendered payment.").

2. Tort ("Bad Faith") Damages

If bad faith is established, i.e., if the insurer's position is found to have been unreasonable, then in addition to its defense fees and costs, an insured may also be able to recover any "tort" damages it has suffered as a consequence of the insurer's breach. *See Campbell v. Superior Court*, 44 Cal.App.4th 1308, 1319–20 (1996). Such damages may include the attorney's fees the insured incurred compelling its insurer to pay the benefits due under the policy. *See Brandt v. Superior Court*, 37 Cal.3d 813, 817 (1985).

3. Punitive Damages

If it can be proven by clear and convincing evidence that the insurer, in denying a duty to defend, has been guilty of oppression, fraud, or malice, the insured may also be entitled to recover an award of punitive damages. *See* Cal. Civ. Code § 3294(a); *Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370, 1375 (9th Cir. 1985) ("[T]here is sufficient evidence to support a finding that Great American refused to defend Tibbs in bad faith and is guilty of oppression, fraud, or malice.").

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This article hopefully leaves business litigators with two key takeaways. First, in light of California's broad, policyholder-friendly "potential for coverage" standard, be skeptical of a liability insurer's assessment that it does not owe your client a duty to defend. And second, given the generous statute of limitations in California, your client may still have time—even long after the litigation has concluded—to challenge an insurer's wrongful refusal to defend and recover back the losses it incurred.

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