

ALERT

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New Ninth Circuit Decision Purportedly Imposes Duty on California Insurers to Negotiate a Settlement within Policy Limits.

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Du v. Allstate Ins. Co., ___ F.3d ___ (June 11, 2012)

The recent *Du v. Allstate Ins. Co.* opinion is the 9th Circuit's *Erie* guess of the proper interpretation of a long-standing issue of California bad faith law: whether an insurer has a duty to attempt to settle within policy limits even if there is no policy limits demand, and, if so, when that duty attaches. The 9th Circuit ruled that an insurer does have the duty to attempt to settle a claim within policy limits when it is "reasonably clear" that the insured's liability is in excess of the policy limits, or it faces bad faith exposure for a judgment in excess of policy limits. The 9th Circuit also ruled that the bad faith defense of the "genuine dispute" doctrine does not apply to settlement of third-party liability claims.

The 9th Circuit decision in *Du* is potentially a license for misuse by plaintiffs trying to manipulate the settlement process to "lift the cap off" policy limits. Decades ago, the California Supreme Court in *Royal Globe Ins. Co. v. Superior Court*, 23 Cal.3d 880 (1979) gave plaintiffs a direct right to bring bad faith claims against insurers for unreasonably failing to effectuate settlements under the same standard adopted by the 9th Circuit in *Du*. However, at the time of *Du*, *Royal Globe* was not the law since in 1988 when the California Supreme Court surveyed the carnage in insurance claims handling created by *Royal Globe* and prohibited both plaintiffs and insureds from pursuing bad faith actions based on Insurance Code section 790.03. See *Moradi-Shalal v. Fireman's Fund Ins. Companies*, 46 Cal.3d 287 (1988). Now the 9th Circuit is attempting to re-open this Pandora's Box in the guise of an assignable bad faith claim of insureds, and the "losers" in this process will be the California insurance industry.

As discussed below, the entire *Du* decision is *obiter dictum* which should not be binding precedent. However, the California federal district courts likely will feel compelled to follow this published decision. Because the California state courts typically ignore 9th Circuit decisions on California insurance law (which they are not required to follow, unlike published state court appellate decisions), this will encourage plaintiffs to bring bad faith cases in federal court under diversity jurisdiction.

Du arose out of an auto accident with one severely injured plaintiff and several other plaintiffs with some injuries. The defendant had a \$100,000 per person/\$300,000 per accident auto liability policy with Allstate. Plaintiffs' attorney made a \$300,000 policy limits demand for all plaintiffs, and refused to separately negotiate each individual plaintiff's claim under the \$100,000 per person limit. The insurer requested additional medical information from the severely injured plaintiff, and subsequently made a \$100,000 separate policy limit offer to that plaintiff, which was rejected. The severely injured plaintiff filed suit and obtained a \$4,000,000 judgment against the insured. Plaintiff took an assignment of the insured's bad faith claim against Allstate for unreasonable failure to settle within policy limits, and filed suit against Allstate.

At the trial of the bad faith action, plaintiff sought a jury instruction that Allstate had a duty to attempt to negotiate a settlement within policy limits when liability of the insured to the plaintiff in excess of policy limits was "reasonably clear." The trial court rejected this jury instruction on the ground that the insurer had no such duty. Instead, the trial court gave the standard jury instruction that Allstate had a

duty to accept a reasonable settlement demand within policy limits, and the jury found that Allstate had not breached that duty, resulting in a judgment in favor of Allstate. Plaintiff appealed on the ground that the trial court erred in refusing to give the jury instruction that Allstate had a duty to attempt to negotiate a settlement within policy limits. The 9th Circuit affirmed the judgment in favor of Allstate, finding that there was no evidence that Allstate had not attempted to negotiate a settlement within policy limits, so there was no reason to give such a jury instruction.

Even though there would be no retrial and therefore no reason to address a jury instruction that an insurer had a duty to attempt to negotiate a settlement within policy limits, the 9th Circuit decided to resolve the scope of the insurer's duty to settle within policy limits. This is classically *dictum*, because it is not necessary to the resolution of the appeal before the court, and can best be described as an "advisory opinion." Although these arguments against the decision can be made in future federal district court cases, federal district court judges will generally feel they are bound to follow this 9th Circuit precedent unless and until the California Supreme Court overrules it.

The 9th Circuit's analysis starts with the unquestioned, long-standing principle of California bad faith law that an insurer has a duty to accept a settlement demand within policy limits if there is a substantial likelihood of a judgment against the insured in excess of policy limits. The reasonable belief of the insurer that there is no coverage for the claim does not justify refusing to accept a policy limits demand if it is subsequently determined that the claim is covered by the policy. An insurer that refuses to accept a policy limits demand based on coverage defenses does so at its own risk. If the judgment against the insured exceeds the policy limits, and the insurer's rejection of the policy limits demand was "unreasonable," then the insurer has extracontractual liability for the full amount of the judgment. Hence, plaintiff in this case was seeking to impose the full \$4,000,000 judgment on Allstate, which only provided coverage for \$100,000 of those damages.

In most claims, after the plaintiff's attorney determines the amount of liability coverage available (which is discoverable in California), plaintiff's attorney will draft a letter to

defense counsel demanding settlement within policy limits. These letters vary in the amount of information provided concerning liability and damages, and it is common for insurers to request additional information, as in fact happened in *Du*. If an insurer rejects a policy limits demand, the insured can immediately enter into a settlement with the plaintiff to assign the insured's bad faith rights against the insurer for a judgment in excess of policy limits, in exchange for a covenant not to execute the judgment against the insured, which insulates the insured's personal assets from a judgment. The assigned rights are not enforceable (i.e., plaintiff cannot sue the insurer on the assigned rights) until after a final judgment is entered against the insured for an amount in excess of policy limits.

As the 9th Circuit noted, the specific issue of whether an insurer has a duty to attempt to negotiate a settlement within policy limits (i.e., make an unsolicited settlement offer) has never been addressed in a published California appellate decision. The 9th Circuit in *Du* adopted the standard in California Insurance Code section 790.03(h)(5) that "specifically identifies as an 'unfair claims settlement practice[],' [n]ot attempting in good faith to effectuate prompt, fair, and equitable settlement of claims *in which liability has become reasonably clear*." (Emphasis added.). The 9th Circuit acknowledged that the California courts have expressly held that there is no private right of action of an insured for violation of section 790.03 standards (*Moradi-Shalal*, discussed above), but relied on a California form jury instruction for bad faith claims that imports the 790.03(h)(5) standard into factors to be considered in determining whether the insurer acted in bad faith.

The 9th Circuit concluded that, under California law, "an insurer can violate the duty of good faith and fair dealing by failing to attempt to effectuate a settlement within policy limits after liability has become reasonably clear." The 9th Circuit did so without a factual record where the insurer actually failed to attempt to effectuate a settlement, and without oral argument that could have explored how this applies in the real world. Thus, the Ninth Circuit had no opportunity to consider the negative side effects of making liability claims adjusting subject to scrutiny after the fact by lay juries addressing "when liability has become reasonably clear."

The case before the court was an easy one – once the large damages were substantiated, the insurer did what insurers normally do: try to settle within policy limits. The problem arises when the insured's liability in excess of policy limits is hard to assess, an issue not addressed by the court. The 9th Circuit decision encourages plaintiffs to engage in trying to "set up" an insurer based on its failure to make policy limits offers early in a case.

Although the 9th Circuit decision offers a sop to insurers by stating that an insurer does not have to make a settlement offer while waiting for additional information requested from plaintiff, that protection must be viewed in the context of an insurer's independent duty to investigate a claim and what is contained in the claims file.

Finally, the 9th Circuit decision purportedly finds that the "genuine dispute" defense does not apply to bad faith arising out of settlement of third-party liability claims. Under California law, if there is a genuine dispute of law or fact with respect to whether there is coverage for a claim, an insurer does not act unreasonably in denying coverage even if the genuine dispute is ultimately resolved against the insurer. The 9th Circuit correctly notes that, under California law, a genuine dispute with respect to whether there is insurance coverage is not a defense to a bad faith claim arising out of refusal to settle within policy limits because the insurer believes there is

no coverage. However, the statement in the decision that the genuine dispute doctrine never applies to settlement of third-party claims is overbroad. In particular, whether the insured's liability has become reasonably clear for purposes of requiring an insurer to negotiate a settlement is inherently likely to involve genuine dispute about both facts and law with respect to the insured's liability, and an insurer should not be compelled to negotiate a settlement even though there is a genuine dispute as to liability of the insured.

The *Du* decision is not yet final, and Allstate filed a petition for rehearing and *en banc* review on June 25, 2012. The 9th Circuit has not yet ruled on that petition. As this is a state law matter, there is no potential for review by the U.S. Supreme Court. We will keep you informed of any further developments concerning this decision.

If you have any questions, please contact Charles Wheeler, Joann Selleck or Amanda Lorenz in Cozen O'Connor's San Diego office or Alicia Curran in the firm's Dallas office.

To discuss any questions you may have regarding the opinion discussed in this Alert, or how it may apply to your particular circumstances, please contact:

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