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PERSPECTIVE

Potential liability for recommending rejection of policy limits demands

By Alan Van Gelder

Consider the following scenario: Smith sues Jones. Insurance Company hires Defense Counsel to defend Jones under the terms of a liability policy with $1 million policy limits. Smith claims damages in excess of the policy limits. Extensive discovery follows. Smith sends Defense Counsel a written policy limits demand. The demand would open up the policy and expose Insurance Company to a claim of bad faith. A bad faith claim means Insurance Company could be on the hook for the entire judgment, even if the judgment exceeds the policy limits. Insurance Company asks Defense Counsel for a recommendation on how to respond to the policy limits demand.

Defense Counsel recommends that Insurance Company reject the policy limits demand. Unfortunately, under this scenario, Defense Counsel has not properly investigated the likely exposure on the case. Had Defense Counsel properly investigated the exposure, Defense Counsel would have recommended accepting Smith's policy limits demand.

The case proceeds to trial and results in a $10 million verdict against Jones. To avoid a certain bad faith claim and mitigate damages, Insurance Company settles with Smith for $9 million. Insurance Company has now paid $8 million more than what it would have paid if Defense Counsel had properly investigated the case. Can Insurance Company sue Defense Counsel for damages, including the $8 million? The short answer is yes.

An insurance company has the right to sue the attorney it hired to represent the insured for legal malpractice. *See Unigard Ins. Group v. O'Flaherty & Belgum*, 38 Cal. App. 4th 1229, 1235 (1995) ("We conclude that when according to insurance policy obligations, an insurer hires and compensates counsel to defend an insured, provided that the interests of the insurer and insured are not in conflict, the retained attorney owes a duty of care to the insurer which will support its independent right to bring a legal malpractice action against the attorney for negligent acts committed in the representation of the insured.")

In *Unigard*, the insurer hired the law firm to defend the insured against a product liability claim. The law firm filed an answer that omitted the important affirmative defense of worker's compensation exclusivity. The law firm was fired and replaced. The successor law firm tried to amend the answer. The court refused to allow the answer to be amended. The insurer paid the limits of the policy to avoid exposing the insured to an excess judgment. The insurer then sued the first law firm for the amount it had to pay on a claim that would have been barred by worker's compensation exclusivity.

With respect to a recommendation to reject a policy limits demand, the recommendation "must have a reasonable basis in terms of the investigation and qualifications of the persons making the decision." *Walbrook Ins. Co. v. Liberty Mut. Ins. Co.*, 5 Cal. App. 4th 1445, 1460 (1992). If defense counsel has not properly investigated the case before recommending a rejection of the policy limits demand, defense counsel is exposing the insurance company to potential bad faith liability. (Which would lead to defense counsel's potential liability to the insurance company as set out in *Unigard*.)

Garamendi v. Golden Eagle Ins. Co., 116 Cal. App. 4th 694, 712, n.9 (2004), is instructive: "If counsel failed to apprise Golden Eagle of its exposure in the litigation, Golden Eagle may have recourse against the attorney, but may not escape the obligations to its insured. (*See, e.g.*, *California State Auto. Assn. Inter-Ins. Bureau v. Parichan, Renberg, Crossman & Harvey* (2000) 84 Cal. App.4th 702, 713–714, disapproved on other grounds in *Viner v. Sweet* (2003) 30 Cal. 4th 1232, 1244, fn. 5 [where attorneys' failure to keep insurance company apprised of the status of litigation resulted in a bad faith judgment against the insurer, the insurer could recover the amount of settlement from attorneys."

With respect to a recommendation to reject a policy limits demand, the recommendation 'must have a reasonable basis in terms of the investigation and qualifications of the persons making the decision.'

In *California State Automotive Association Inter-Insurance Bureau v. Parichan*, 84 Cal. App. 4th 702, 712 (2000), the insurer hired a lawyer to defend the case. The defense lawyer received a Section 998 offer for $50,000 (policy limits) and recommended rejection of the demand. The defense lawyer did not provide the insurance company a key medical report that showed potential exposure well above the $50,000. The case settled for $850,000 on the eve of trial. The insurer sued the defense lawyer. In upholding the verdict against the defense lawyer, the court wrote, "Specifically, one of CSAA's interests was to properly carry out its obligation to evaluate, in good faith, a policy limits settlement offer of an excess claim. In evaluating such an offer, CSAA was required to make an 'honest, intelligent, and knowledgeable evaluation of the offer on its merits …' *Merritt v. Reserve Ins. Co.* (1973) 34 Cal. App. 3d 858, 873 (*Merritt*).) CSAA's failure to do so could expose it to a bad faith claim. fn. 3 In hiring Parichan, therefore, CSAA reasonably expected the law firm to assist it in meeting this obligation. As one court tells us, 'this legal duty [to evaluate settlement offers] is exercised normally in conjunction with the judgment of counsel defending the cases against the insured.' (*Garner v. American Mut. Liability Ins. Co.* (1973) 31 Cal. App. 3d 843, 848.) CSAA alleged that Parichan negligently failed to carry out this duty when, after receipt of the section 998 offer, Parichan did not forward the Schuyler report to CSAA. Parichan's negligence caused CSAA exposure to a potential bad faith lawsuit, an exposure that would not have existed had Parichan forwarded the Schuyler report to CSAA."

If defense counsel's conduct falls below the standard of care in recommending the rejection of a policy limits demand, the attorney not only risks exposing the carrier to a bad faith action but also risks personal exposure to a subsequent legal malpractice action. ■

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