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Reservation of Rights Does Not Mandate Independent Counsel

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Twenty-two years ago the Legislature enacted Civil Code Section 2860 to address the abuses that arose following publication of the *San Diego Navy Federal Credit Union vs. Cumis Insurance Society, Inc.,* 162 Cal. App. 3d 358 (1984) decision. Since then, 2860 has proved effective in reducing those abuses and courts have provided meat to its legislative bones. Still, some confusion remains regarding its application.

Insured defendants too often demand independent counsel simply because a liability insurer agrees to defend but reserves its rights. Such a demand is without legal foundation. Neither *Cumis* nor 2860, which gives the right to independent counsel, requires an insurer to pay for independent counsel whenever the insurer defends under a reservation of rights. Independent counsel is owed only if the reservation of rights creates a significant and actual conflict of interest for counsel retained by the insurer. *Dynamic Concepts, Inc. v. Truck Ins. Exchange,* 61 Cal. App. 4th 999, 1006-1007 (1998).

There must be evidence that the outcome of the coverage issue can be controlled by counsel first retained by the insurer for the defense of the underlying claim. *James 3 Corp. v. Truck Ins. Exchange,* 91 Cal. App. 4th 1093, 1108 (2001). Such a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage, or because the insured is sued for an amount in excess of the policy limits or punitive damages (2860(b)), or because the insurer simply disputes coverage. *Golden Eagle Ins. Co. v. Foremost Ins. Co.,* 20 Cal. App. 4th 1372, 1394 (1993).

Nor is independent counsel required if the coverage issue that is reserved is independent of the issue that is being litigated. *James 3 Corp. v. Truck Ins. Exchange*. For example, independent counsel is not owed if the insurer reserves its rights about whether the defendant is an "insured" under the policy (*McGee v. Superior Court,* 176 Cal.App.3d 221, 227-227 (1985)), or because the damages sought are only partially covered by the policy. *Blanchard v. State Farm Fire & Casualty*, 2 Cal.App.4th 345 (1991). Consequently, the right to independent counsel should never be assumed.

On the contrary, each demand for independent counsel must be carefully examined by the insurer for a triggering conflict of interest. If such a conflict is not present, independent counsel is not owed. If independent counsel is provided without such a conflict, 2860 may not apply and the insurer may find the protections of 2860 unavailable.

In *County of San Bernardino v. Pacific Indemnity Co.*, (1997) 56 Cal App 4th 666, a county sued its liability insurer and the trial court found that 2860 applied to limit the attorney fee rate that the insurer was required to pay in defending the county in an underlying lawsuit. The court of appeal reversed finding that 2860 applies only when a significant and actual conflict of interest would arise for counsel appointed by the insurer. Since the court found no such conflict, the court found 2860 inapplicable.

If on the other hand, such a conflict is found and control of the defense passes to the insured, the insurer must determine the attorney fee rate that will fulfill its obligations under the policy. 2860 limits those rates to those "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 claim arose or is being defended." Under this provision the insurer reviews its history and identifies similar actions in the community where the incident occurred, or where the action is being litigated, and the insurer defended with counsel of its choosing. Whatever rate it paid to its counsel for such actions becomes the rate 2860 requires it to pay independent counsel.

Insureds, however, too often complain that the attorney fee rate charged by counsel it selects is higher than the 2860 rate that the insurer is required to pay. These insureds seem to forget, or are unaware, that this discrepancy is typically because the insurer is a large, highly sophisticated, institutional

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consumer of legal services and can guarantee payment, which enables it to negotiate much better rates than an insured that is only an occasional user of such services and who may not be able, or is unwilling, to guarantee payment. As a result insureds commonly seek ways to avoid the rate limitations of 2860.

For example, if more than one insurer agrees to defend and reserves rights, insureds may argue that the higher rate of independent counsel should be absorbed by the insurers because the share of each insurer is lower than their individual 2860 rate. Courts, however, have rejected this approach. In *San Gabriel Valley Water Co. v. Hartford Accident & Indemnity Co.,* 82 Cal App 4th 1230 (2000), the insured chose independent counsel that billed hourly rates over double the hourly rates the insurers ordinarily paid for defense of similar actions in the community. The insured argued that the insurers combined were required to pay the independent counsel's full rate. The insurers argued that 2860 applied to the insurers collectively. The trial court agreed with the insurers and granted judgment in their favor. The court of appeal affirmed, holding that in a multiple-defendant action 2860 provided a single rate limitation.

These types of rate disputes are endemic to 2860. Insurers for their part have attempted to resolve or avoid rate disputes by negotiating rates directly with independent counsel. (Negotiated rates are almost always higher than 2860 rates.) In the alternative insurers and independent counsel often agree on a rate with both sides reserving their rights to litigate the rate issue at the conclusion of the litigation. 2860 requires that all rate disputes, including those mentioned, be "resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute." This procedure is mandatory and cannot be waived by the refusal of an arbitration demand. In fact, courts are without jurisdiction to adjudicate these disputes. *Long v. Century Indemnity Co.,* 163 Cal.App.4th 1460, 1471 (2008).

While arbitration only applies to attorney fees (*Gray Cary Ware & Freidenrich v. Vigilant Insurance Company,* 114 Cal.App.4th 1185, 1192 (2004)) it applies even if the fee dispute is just one part of a larger matter. *Compulink Management Center, Inc. v. St. Paul Fire & Marine Insurance Co.,* 169 Cal.App.4th 289, 300 (2008). The only exception to this rule appears to be where the insurer sues independent counsel for fraudulent billing practices and the 2860 rate dispute is part of that litigation.

This situation occurred in *Fireman's Fund Ins. Company v. Younesi,* 48 Cal.App. 4 451 (1996). There legal billings were a central issue but the court found a fraud trial was a better forum for deciding the issues raised by the complaint, which included that independent counsel was part of a scheme to cheat insurance companies, converted property, committed malpractice, and made misrepresentations. Similarly, in *Caiafa Prof. Law Corp. v. State Farm Fire & Cas. Co.,* 15 Cal App 4th 800 (1993) the court of appeal affirmed a trial court's exercise of discretion in denying a petition for 2860 arbitration in a case in which an insurer had sued independent counsel nine months earlier in federal court for fraudulent billing practices. It found the trial court could have reasonably decided that the rights of the parties were best determined by the federal courts since the federal action raised broader issues than the amount of counsel fees and that an arbitration stay was necessary to avoid an unseemly conflict with another court.

In addition to determining the right to independent counsel and appropriate fees, 2860 also governs the relationship between independent counsel and the insurer that pays its bills. Such counsel must inform and consult with the insurer in a timely manner, disclose to the insurer all known, nonprivileged information, and cooperate in exchanging information with insurer provided counsel, if any. Failure to fulfill these obligation may give rise to a claim by the insurer against independent counsel. *Vance v. Villa Park Mobilehome Estates*, 32 Cal App 4th 64 (1995).

Finally, a liability insurer retains the right to control settlement even if independent counsel is owed and retained. Neither 2860 nor case law suggests that independent counsel's control of the insured's defense extends to preventing the insurer from exercising its contractual right to settle a claim as the insurer deems expedient. *Western Polymer Technology, Inc. v. Reliance Ins. Co.,* 32 Cal App 4th 14 (1995).

Although 2860 will continue to evolve, it has proven over 22 years that it is an effective piece of legislation providing much needed guidance to insurers and lawyers alike.