Bloomberg Law

Professional Perspective

Strategies to Maximize the Recovery of Attorney's Fees From a Breaching Insurer

Keith A. Meyer, Reed Smith

Strategies to Maximize the Recovery of Attorney's Fees From a Breaching Insure

Contributed by Keith A. Meyer, Reed Smith

The twin cornerstones of liability insurance policies are the insurer's promise to defend its insured against potentially covered claims and the duty to indemnify its insured for settlements or judgments covered by the policy. While the duty to indemnify is obviously critical, given the sheer costs of modern day litigation, an insurer's obligation to defend is often considered to be more important to the insured than its promise of indemnity.

As noted by the California Supreme Court, "[t]he insured's desire to secure the right to call on the insurer's superior resources for the defense of third party claims is, in all likelihood, typically as significant a motive for the purchase of insurance as is the wish to obtain indemnity for possible liability." *Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th 287, 295-96 (1993).

When the insurer wrongfully fails to defend, the insurer has denied its insured one of the most valuable promises under the policy. It forces the insured to expend valuable resources to fund its own defense, sums that are necessarily diverted from other useful purposes. When an insured sues to recover those expenses, the first step is for a court to find that the insurer breached its duty to defend. When the insured then seeks to recover its defense costs as damages, insurers typically advance similar arguments, but courts have provided jilted insureds with various evidentiary presumptions that should be used to respond to many of these arguments.

When an insurer is found to have breached the duty to defend, some courts hold that the insured's defense costs are presumed to be reasonable and necessary. Other courts assume that market incentives can be used to demonstrate the reasonableness of the defense costs incurred. Still other courts hold that a breaching insurer waives the right to challenge the reasonableness or necessity of defense costs or second-guess the insured's defense strategy. This article will examine the standard contentions advanced by breaching insurers to avoid or minimize the payment of past defense costs and the arguments that insureds can use to maximize their recovery.

The Insurer's Duty to Defend

The recovery of past defense costs under a liability policy is premised on the insurer's breach of its duty to defend. Under the law of nearly every jurisdiction, a liability insurer owes a broad duty to defend its insured against claims that are potentially covered under its policy of insurance. As a result, the duty to defend is often said to be broader than the duty to indemnify because defense coverage is not dependent on whether coverage is ultimately established, but merely on whether a claim is potentially covered under the policy. Thus, the mere possibility that a claim might be covered under the insurer's policy is typically deemed sufficient to trigger the duty to defend. See, e.g., *Montrose*, 6 Cal. 4th at 295-96, 300 (to trigger an insurer's defense obligation, there only has to be a "'bare potential' or 'possibility' of coverage"); *Frog, Switch & Mfg. Co. v. Travelers Ins. Co.*, 193 F.3d 742, 746 (3d Cir. 1999) (duty to defend "arises whenever an underlying complaint may 'potentially' come within the insurance coverage").

Because the duty to defend is broader than the duty to indemnify, an insurer may owe a duty to defend its insured where coverage is in doubt and ultimately does not develop or in an action in which no damages are ultimately awarded. *Montrose*, 6 Cal. 4th at 295; *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal. 4th 1076, 1081 (1993). This means that the duty to defend extends even to groundless, false or fraudulent claims. Id. at 1086; *Penn Am. Ins. Co. v. Peccadillos, Inc.*, 27 A.3d 259, 265 (Pa. Super. Ct. 2011).

Even if there is nothing more than a bare potential for coverage, an insurer's defense obligation is triggered, and "[a]ny doubt as to whether the facts establish the existence of the defense duty must be resolved in the insured's favor." *Montrose*, 6 Cal. 4th at 295-96, 299-300. When an action involves both potentially covered and non-covered claims, the insurer must defend the entire suit, including claims that are not covered. *Buss v. Superior Court*, 16 Cal. 4th 35, 48-49 (1997).

While an insured can invoke the insurer's duty to defend by showing a "bare potential" for coverage, an insurer can avoid its defense obligation only if it can show that the complaint "can by no conceivable theory raise a single issue which could bring it within the policy coverage." *Montrose*, 6 Cal. 4th at 300 (citation omitted); *State Farm Fire & Cas. Co. v. DeCoster*, 67 A.3d 40, 45 (Pa. Super. Ct. 2013) (quoting *Penn-Am. Ins.*, 27 A.3d at 265) ("Pennsylvania recognizes that a duty to defend is broader than the duty to indemnify.

Accordingly, even if there are multiple causes of action and one would potentially constitute a claim within the scope of the policy's coverage, the insurer would have a duty to defend until it could confine the claim to a recovery excluded from the policy."). Thus, an insured "need only show that an underlying claim *may* fall within the policy coverage; the insurer must prove it *cannot*." *Montrose*, 6 Cal. 4th at 300.

Most jurisdictions require an insurer to defend its insured until there is no longer any potential of coverage under the insurer's policy. Id. at 295 ("[t]he defense duty is a continuing one, arising on tender of defense and lasting until the underlying lawsuit is concluded, or until it has been shown that there is *no*potential for coverage"); *United Servs. Auto. Ass'n v. Elitzky*, 517 A.2d 982, 985 (Pa. Super. Ct. 1986) ("As long as the complaint comprehends an injury which may be within the scope of the policy, the [insurer] must defend the insured until the insurer can confine the claim to a recovery that the policy does not cover.").

When the duty to defend is triggered, the insurer has an obligation to pay the full amount of the defense costs incurred, not just a proportionate share. *Buss*, 16 Cal. 4th at 49 ("To defend meaningfully, the insurer must defend immediately. To defend immediately, it must defend entirely").

The result of these principles is that an insurer's broad and fundamental defense obligation is triggered upon any allegation or factual dispute raising the possibility of coverage under the insurer's policies, and continues until the insurer can prove there is no longer any possibility of coverage.

Damages for Breach of the Duty to Defend

When an insurer breaches the duty to defend, the normal contract damages are the costs of the defense. "An insurer who denies coverage does so at its own risk, and, although its position may not have been entirely groundless, if the denial is found to be wrongful it is liable for the full amount which will compensate the insured for all the detriment caused by the insurer's breach of the express and implied obligations of the contract." *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 660 (1958). See *Emerald Bay Cmty. Ass'n v. Golden Eagle Ins. Corp.*, 130 Cal. App. 4th 1078, 1088-89 (2005) (insured's damages are "the costs and attorney's fees expended by the insured defending the underlying action"); *Zurich Ins. Co. v. Killer Music, Inc.*, 998 F.2d 674, 680 (9th Cir. 1993) (by breaching the duty to defend, insurer was liable for attorney's fees "'incurred in good faith, and in the exercise of a reasonable discretion' in defending the action" including attorney's fees "arguably allocable to defense of noncovered claims").

When an insured tries to recover those costs from a breaching insurer, the same insurer will inevitably create various roadblocks to full payment. It will likely insist on reviewing the law firm invoices and maintain that it is only responsible for "reasonable" and "necessary" defense expenses. See, e.g., *Marie Y. v. Gen. Star Indem. Co.*, 110 Cal. App. 4th 928, 960-61 (2003) ("Where an insurer is liable for breach of contract to defend (but not indemnify) an insured, and where the insurer is *not* guilty of tortious bad faith, and where the insured in fact retains counsel to defend the claim, the proper measure of damages is the reasonable attorneys' fees and costs incurred by the insured in the defense of the claim.").

The insurer may also drag its feet and delay any reimbursement until it receives an assessment from a "professional" billing auditor hired by the insurer, who will be paid to comb through the insured's defense bills and object in hindsight to any charges thought to be "unreasonable" or "unnecessary." Armed with the results of its fee auditor, the insurer will object to the hourly rates, question the staffing of the case, argue that the case was managed inefficiently and perhaps even question the results achieved.

While the insured may ultimately have to hire its own "fee expert" to rebut the insurer's fee auditor, insureds may be able to take advantage of various evidentiary presumptions, as well as common sense arguments, to convince a court that it can avoid the task of scrutinizing past defense costs to determine if they were reasonable and necessary. Indeed, given the

reluctance of many courts to devote the time and resources necessary to undertake a detailed review of defense bills, especially when those bills cover many years of defense work, insureds should take advantage of these strategies to help maximize their recoveries, avoid a mini-trial on their past defense costs and strategies and conserve the court's limited resources.

Recovering Attorney's Fees for Breach of Duty to Defend Presumption of Reasonableness

Some courts hold that where the insurer has breached its duty to defend, costs incurred by the insured are presumed to be reasonable and necessary, and the burden shifts to the insurer to rebut this presumption. Thus, under this presumption, the insured need only show the "existence and amount of the … expenses [it incurred], which are then presumed to be reasonable and necessary as defense costs …" *Aerojet-Gen. Corp. v. Transp. Indem. Co.*, 17 Cal. 4th 38, 64 (1997). In *State v. Pac. Indem. Co.*, 63 Cal. App. 4th 1535, 1548-49 (1998) (quoting *Aerojet*, 17 Cal. 4th at 64), the court explained that where the insurer has breached its duty to defend, "it is the insured that must carry the burden of proof on the existence and amount of the … expenses, which are then presumed to be reasonable and necessary as defense costs, and it is the insurer that must carry the burden of proof that they are in fact unreasonable or unnecessary."

Market Incentives Create a Presumption of Efficiency

When pushing back against a breaching insurer that challenges the reasonableness or necessity of the insured's past defense costs, the insured should also rely on its own incentive to economize because it would not be reasonable for an insured to overspend on defense expenses, particularly when it had no assurance that the insurer would ever foot the bill. Indeed, an insured that has been abandoned by its insurer has every incentive to negotiate for favorable hourly rates and achieve every possible efficiency in the conduct of its defense. In *Taco Bell Corp. v. Continental Casualty Co.*, 388 F.3d 1069 (7th Cir. 2004), the Seventh Circuit confirmed this basic principle and held that where an insurer breached the duty to defend, market incentives established a presumption that the attorney's fees incurred were reasonable.

The court noted that after the insurer had denied coverage, Taco Bell hired its own defense counsel and therefore "Taco Bell had an incentive to minimize its legal expenses (for it might not be able to shift them); and where there are market incentives to economize, there is no occasion for a painstaking judicial review." The court added that "the duty to defend would be significantly undermined if an insurance company could, by the facile expedient of hiring an audit firm to pick apart a law firm's billing, obtain an evidentiary hearing on how much of the insured's defense costs it had to reimburse."

Other courts hold that the insured's payment of "its own defense costs without assurance of reimbursement is 'compelling evidence' that the costs were reasonable and necessary." *Post v. St. Paul Travelers Ins. Co.*, 752 F. Supp. 2d 499, 512 (E.D. Pa. 2010), *rev'd on other grounds*, (citing *Rite Aid Corp. v. Liberty Mut. Fire Ins. Co.*, No. 03-1801, 2006 WL 2376238, at *4 (M.D. Pa. Aug. 14, 2006)). Even non-insurance cases are in accord. For example, in *Medcom Holding Co. v. Baxter Travenol Labs, Inc.*, 200 F.3d 518, 520 (7th Cir. 1999), the court held that "reasonableness must be assessed using the market's mechanisms." The court noted that "[t]he fees in dispute here are not pie-in-the-sky numbers that one litigant seeks to collect from a stranger but would never dream of paying itself. These are bills that MHC *actually paid* in the ordinary course of its business."

When assessing the reasonableness of the defense effort, insurers regularly dispute the hourly rates charged by law firms hired by the insured and insist that they should not have to pay hourly rates beyond the rates that they would ordinarily pay their panel counsel to defend comparable actions. This argument should also be rejected. An insurer cannot deny coverage and thus surrender control of the defense, and then expect that if it is found to have breached the policy, it is only liable for the same amount of legal fees that it would have paid if it had accepted coverage and retained control of the defense.

"What is reasonable is not what an insurance company would pay to the attorneys it would retain, but what a reasonable person in the insured's position would pay for capable attorneys it chose to retain." *Watts Water Techs. v. Fireman's Fund Ins. Co.*, No. 05-2604-BLS2, 2007 WL 2083769, at *10 (Mass. Super. Ct. July 11, 2007). Nor is an insured required to hire the cheapest attorneys it can find. *Ripepi v. Am. Ins. Cos.*, 234 F. Supp. 156, 158 (W.D. Pa. 1964) ("Plaintiff was not required to

employ the cheapest lawyer he could get, or solicit competitive bids or hire a starving, obscure young practitioner … [P]laintiff here was not obliged to shop around before retaining competent and capable counsel.").

In a non-insurance case, the Second Circuit has held that hourly rates paid by a client are presumptively reasonable. In *Arbor Hill Concerned Citizens Neighborhood Association v. County of Albany*, 522 F.3d 182, 190 (2d Cir. 2008), the Second Circuit explained that "the reasonable hourly rate is the rate a paying client would be willing to pay" and that "a reasonable, paying client wishes to spend the minimum necessary to litigate the case effectively." The court reasoned that "by focusing on the hourly rate at which a client who wished to pay no more than necessary would be willing to compensate his attorney, the district court can enforce market discipline …"

Insurers also regularly resist the payment of more than one firm to defend the insured. But if the underlying litigation is pending in multiple forums it may be inevitable that multiple defense counsel must be used. Indeed, when insureds are sued in mass tort cases, engaging national coordinating counsel to oversee the defense effort in multiple jurisdictions is often viewed as a reasonable defense strategy. See, e.g., *Caterpillar, Inc. v. Century Indem. Co.*, No. 3-09-0456, 2011 WL 488935, at *3 (Ill. App. Ct. Feb. 1, 2011) (finding that insured's use of "regional teams with day-to-day responsibilities for handling the claims" and "national coordinating counsel … to implement a uniform, nationwide, common defense strategy" was reasonable); *Legacy Partners, Inc. v. Travelers Indem. Co. of Ill.*, 83 F. App'x. 183, 187 & n.2 (9th Cir. 2003) ("In a lawsuit threatening millions in damages, the use of five law firms is not per se unreasonable"; "[e]ven if the law firms spent some of their time coordinating among themselves, such time qualifies as time spent defending [the insured] in what by all accounts was a large case with potentially massive damages."); *Watts Water*, 2007 WL 2083769, at *8 (holding that there was nothing "inherently unreasonable" about insured retaining national counsel and other law firms as local counsel to represent it in 300 underlying asbestos lawsuits in a dozen states).

Attempts to Limit Reimbursement to the Insurer's Proportionate Share

Faced with having to reimburse an insured's past defense costs, insurers will often look for other potentially responsible insurers to share the burden and insist that the breaching insurer is only obligated to reimburse its proportional share of such costs. This argument misses the mark.

When an insurer owes a duty to defend, it must pay 100% of the insured's defense costs, and it can seek contribution from other insurers separately. See *Haskel, Inc. v. Superior Court*, 33 Cal. App. 4th 963, 976 n.9 (1995) (emphasizing that if an insurer "owes any defense burden" at all, it must "fully b[ear]" it, "with allocations of that burden among other responsible parties to be determined later."). Indeed, in *Pacific Indemnity*, 63 Cal. App. 4th at 1548, the court held that an insurer, which was on the risk for only one of 43 years of continuing environmental damage, was required to provide the insured's entire defense, even though the insured had elected to self-insure itself for the other 42 years. The court confirmed the rule against the proration of defense costs, holding that "Pacific Indemnity's argument that its duty to defend should be apportioned … based on the one year of its coverage is contrary to California law."

In *Haskel*, the court held that the insurer's acceptance of 13% of the defense burden was held to be "the equivalent of a defense denial." *Haskel*, 33 Cal. App. 4th at 976 n.9. If an insurer is not permitted to limit its defense obligation to its "pro rata share" when it owes a duty to defend, then there is no justification to limit the reimbursement of those defense expenses to a fractional share after it breaches the duty to defend.

Waiver of the Insurer's Right to Dispute Reasonableness

Some courts even hold that an insurer that wrongfully fails to defend cannot thereafter dispute the amount or the reasonableness of the defense fees and costs that the insured was forced to incur on its own. These cases reason that an insurer that breaches its defense obligation waives or forfeits the ability to challenge the reasonableness of the fees incurred by the insured, or second-guess the strategic decisions undertaken in connection with that defense. *Pac. Indem.*, 63 Cal. App. 4th at 1555 ("an insurer which wrongfully refuses to defend loses control over the management of the claim"); *USF Ins. Co. v. Clarendon Am. Ins. Co.*, 452 F. Supp. 2d 972, 1005 n.94 (C.D. Cal. 2006) ("It is well settled that an insurer that declines to defend waives its right to challenge the reasonableness of defense costs.")

While these decisions appear to be a minority view, the rationale behind these decisions is unassailable: an insurer that abandons its insured should not be permitted to play Monday morning quarterback and question defense-related decisions that the insured was forced to make on its own, and without the benefit or guidance that the insurer would have normally provided. Not only should the insured not be placed in a worse position than it would have been if the insurer fulfilled its duty to defend, but the consequence of waiver provides a strong incentive for the insurer to fulfill its duty to defend in the first place.

Courts May Avoid a Meticulous Review of Fee Records

In ruling on the reasonableness of an insured's past defense costs, courts will often steer clear of having to conduct a detailed or minute analysis of the underlying claims as well as the nature and effort of the defense strategy. Given the presumption that the defense costs are assumed to be reasonable and necessary, coupled with common sense market incentives to not overpay for defense costs, courts increasingly balk at any suggestion to engage in an exhaustive review of attorney's fee invoices. See *Krueger Assocs., Inc. v. ADT Sec. Sys.*, 2000 WL 10394, at *3 (E.D. Pa. Jan. 5, 2000) (citation omitted) ("We find it necessary also to observe that we did not and do not intend that a district court, in setting an attorneys' fee, become enmeshed in a meticulous analysis of every detailed facet of the professional representation … Once the district court determines the reasonable hourly rates to be applied, for example, it need not conduct a minute evaluation of each phase or category of counsel's work.").

Indeed, some courts have even found that itemization and detailed bills are not necessarily required. See *Medcom Holding*, 200 F.3d at 520 ("Itemization is far less common when businesses pay their own lawyers, for having attorneys keep detailed records is a cost that many clients prefer to avoid … If attorneys submit bills that meet market standards of detail, their omission of information to which courts resort in the absence of agreement is of no moment. If the bills were paid, this strongly implies that they meet market standards.") Having breached the duty to defend, the insurer is in no position to insist that the insured provide billing records that meet the insurer's billing standards when the insurer declined to participate in the defense in the first place.