

CASE STUDY PREPARED FROM ORIGINAL PUBLISHED OPINION

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Intergulf Development v Superior Court (3/24/2010)

Bad Faith; Civil Code section 2860; Attorney fees

Intergulf was sued for alleged construction defects in a condominium project in downtown San Diego. Interstate Fire & Casualty insured Intergulf from liability for property damage. On March 19, 2007, Intergulf tendered the construction defect claims and demanded that Interstate defend and indemnify Intergulf as an additional insured in policies issued to its subcontractor. Interstate responded that it would investigate under a “**full and complete reservation of rights.**” On November 8, 2007, Interstate acknowledged receipt of tender and agreed to participate in Intergulf’s defense through the Wood, Smith law firm, subject to the reservation of rights.

Ten days later, Intergulf objected in writing to the defense by Interstate’s counsel, cited *Cumis* and section 2860, and requested appointment of counsel of Intergulf’s choice. There was no response from the carrier. On November 29, 2007, Intergulf requested immediate reimbursement for its defense costs and reaffirmed its demand for independent counsel. Again, there was no response. The demand was reiterated by Intergulf in January, 2008, and again, there was no response.

Intergulf sued Interstate for bad faith, breach of contract and declaratory relief. It acknowledged two payments by Interstate toward defense costs, totaling \$238,000. Five weeks before trial, Interstate filed a petition to compel arbitration of a “*Cumis Fee Dispute.*” Counsel for the carrier declared that Luce, Forward, Intergulf’s independent counsel was “*attempting to charge legal fees far in excess of those actually paid by Interstate in the normal course of business, to attorneys retained by it to defend similar actions ...*”

Civil Code section 2860(c) states: When the insured has selected independent counsel to represent him or her, the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum

qualifications....The insurer's obligation to pay fees to the independent counsel...is limited to the rates 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....Any dispute concerning attorney's fees.... shall be resolved by final and binding arbitration....

Intergulf responded that the action was about damages the carrier owed for breaching its duty to defend. Since the questions of bad faith and duty to defend had not yet been resolved, the prerequisites for a fee arbitration under 2860(c) had not been satisfied. The parties took opposite positions whether Interstate had ever acknowledged Intergulf's right to independent counsel. The trial court granted Interstate's petition to compel arbitration and continued the trial pending completion of arbitration. Intergulf then petitioned for a writ of mandate which was denied by the Fourth DCA. The California Supreme Court then granted Intergulf's petition for review and the matter was returned to the Fourth with directions to vacate the order denying mandate and to issue an order to show cause why Intergulf's request for relief should not be granted. The Justices of the Fourth DCA looked to the nature of the action, a bad faith and breach of contract claim, not a dispute over the amount the carrier should pay as attorney fees. Unreasonable delay in paying policy benefits or paying less than the amount due is actionable withholding of benefits which may constitute a breach of contract as well as bad faith giving rise to damages in tort. (*Wilson v 21st Century Ins. Co.* (2007) 42 Cal.4th 713) The general measure of damages for breach of duty to defend consists of the insured's cost of defense in the underlying action, including attorney fees. (*Emerald Bay Community Assn. v Golden Eagle Ins. Corp.* (2005) 130 Cal.App.4th 1078)

Breach of the duty to defend also results in the insurer's forfeiture of the right to control defense of the action or settlement, including the ability to take advantage of the protections and limitations set forth in section 2860. (*Fuller-Austin Insulation Co. v Highland Ins. Co.* (2006) 135 Cal.App.4th 958) By filing the action in this case, Intergulf gave notice it was treating Interstate's failure to acknowledge the right to independent counsel and delay in paying policy benefits as a total breach of the duty to defend.

Intergulf's entitlement to damages for breach of contract and bad faith turns on (1) whether Interstate owed Intergulf a duty to defend in the first instance, and (2) whether Interstate breached that duty by failing to defend

Intergulf “immediately” and “entirely” on tender of the defense. (*Buss v Superior Court* (1977) 16 Cal.4th 35) Neither of these questions had been resolved when the trial court granted the carrier’s petition to compel arbitration of the fee dispute. Interstate and the trial court relied on *Compulink Management Center, Inc. v St Paul Fire & Marine Ins. Co.* (2008) 169 Cal.App.4th 289) which construed 2860(c) to require binding arbitration of all contested issues concerning the amount of fees owed independent counsel. The Fourth DCA pointed out that the *Compulink* case did not involve the preliminary question of duty to defend or disputes over if and when the insurer recognized the insured’s right to select independent counsel. Instead, it was a dispute over the amount to be paid independent counsel. The dispute was over the amount of fees paid, not whether the independent counsel would defend the insured in the third party litigation. The Justices rely on this distinction. An order granting the petition of Interstate to arbitrate fees might suggest Interstate satisfied its obligations under 2860. If Interstate can turn to 2860(c) before the questions of duty to defend and breach are determined by the trial court, an arbitrator will decide if Luce Forward charged fees “far in excess” of amounts actually paid by Interstate to attorneys in that community. If, on the other hand, Intergulf proves that Interstate owed it a duty to defend and breached that duty and/or committed bad faith as alleged, the trier of fact will apply the contract measure of damages in the trial court and Interstate will owe all of Luce Forward’s charged fees.

Under these circumstances a premature determination Interstate is entitled to fee arbitration under 2860(c) may **prejudice** Intergulf’s claim that the carrier failed to accept the selection of independent counsel and pay its share of defense costs in a timely manner—a factual question at the heart of Intergulf’s breach of contract and bad faith claims. As such, the trial court abused its discretion by granting the carrier’s petition to compel arbitration under 2860(c) before the parties resolved the issues raised by Intergulf’s complaint. Interstate may pursue its remedies under 2860 at a later time, if appropriate.

A peremptory writ shall issue directing the trial court to vacate its order to compel arbitration, and enter an order denying the petition. Intergulf is entitled to costs.