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Insurer's Duty to Defend

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The duty to defend the insured in litigation is a fundamental provision of insurance contracts covering claims by third parties. As in other jurisdictions, this duty is a frequent source of litigation in California or at the very least presents daily problems of interpretation to both plaintiff and defense lawyers and insurance industry personnel; all this, despite the California Supreme Court's definitive treatment of the subject in *Gray v. Zurich Insurance Co.*

This article will trace the development of the substantive law both before and after the *Gray* decision and will identify some of the problems and risks faced daily by insurance industry personnel and will make some recommendations for handling the duty to defend problem.

**SUBSTANTIVE LAW BEFORE GRAY**

The initial California case dealing with the duty to defend is *Greer-Robbins Co. v. Pacific Surety Co.* decided in 1918 by the Second Dis-
strict Court of Appeal. Here, the insured, Greer-Robbins Company brought an action against its insurer for the recovery of the cost and expense incurred by the insured in defending the claims of one Hill. Of note is the fact that both the insured and insurer agreed that the insured was not entitled to indemnification for the subject claim. Hence, the case was decided purely on the question of whether or not the insured was entitled to recover the cost and expense which it had incurred in defending the Hill action upon the refusal of the insurer to do so.⁴

On appeal, the insurer contended that whether or not it owed a defense to its insured depended upon the outcome of the third party litigation or, simply stated, whether it had a duty to defend could only be determined after the time for the performance of the obligation had entirely elapsed rather than before it had commenced to run. This logic was unpersuasive to the Court of Appeal, which, among other things, noted that were this position to be adopted in all cases, it would work an alteration of the very language of the policy, making the words "will defend" meaningless, and likewise the duty to defend meaningless. It was clear to the court that upon an independent investigation, or even in the absence thereof, an insurer could decline to defend thus imposing upon the insured a duty to defend in every case. Accordingly, the Court of Appeal stated:

There is a more certain basis for a determination of the liability of the appellant (insurer) to defend, and that basis is to be found in the allegations of the complaint in each action for damages against the respondent (insured). We construe the policy to mean that it is a duty of the appellant (insurer), under its terms, to defend every action in which the complaint shows 'a claim for damages covered by this policy.'⁵

The rule adopted by the Court of Appeal in the Greer-Robbins opinion is the majority rule in the United States and is sometimes referred to as the "traditional rule."⁶

⁴. The exact language of the Pacific Surety Company policy as pertains to its duty to defend is as follows:

In addition to the limits hereinafter specified, if any suit is brought against the assured to enforce a claim for damages covered by this policy, the company will defend such suit, whether groundless or not, in the name and on behalf of the assured. The expenses incurred by the company in defending such suit, including costs, if any, taxed against the assured, will be borne by the company, whether the judgment is for or against the assured. If any suit, even if groundless, is brought against the assured to recover damages on account of injuries or deaths covered by this policy, the assured shall immediately forward to the company, or to the office of its nearest authorized general agent, every summons or other process served, or copy thereof, thereupon the company will, at its own cost and expense, defend such suit in the name and on behalf of the assured.

⁵. Id. at 543, 174 P. at 111.

Given the fact that *Greer-Robbins* stated the traditional rule, it is interesting to note that appellate decisions in California with respect to the duty to defend were totally absent until 1935. Some 17 years later, the First Appellate District, Division One, of the Court of Appeal made its decision in *Lamb v. Belt Casualty Co.*

The *Lamb* case arose as a dispute between two separate insurance carriers. In particular, the case concerned whether the two carriers owed a duty to defend and indemnify the owner of the insured property. The Court of Appeal followed the general rule set forth in the *Greer-Robbins* case by stating that "the language of its contract must first be looked to, and next the allegations of the complaints in each action for damages against the insured." The Court of Appeal, after concluding that the refusal to defend the suit was wrongful, concluded that:

the denial of liability on the part of the insuring company and its refusal to defend the suits constituted such a breach of the contract that the insured was released from his obligation to leave the management thereof to it, and was justified in proceeding to defend on his own account.

The court pointed out that in the event the insurer refused to defend, any judgment in the underlying action was conclusive evidence that the insured was liable to the extent of the amount of the judgment. When, however, there was no trial and no judgment, but there was a settlement of the litigation, the question whether the liability of the insured was one which the contract of insurance covered would remain open, as would the question of liability and the extent thereof. The court recognized that these questions could properly be determined in an action by the insured to recover the amount paid in settlement of the litigation. Under such circumstances the settlement becomes presumptive evidence only of the liability of the insured and the amount thereof.

The issue of when the duty to defend arises was once again discussed in depth in *Maxon v. Security Insurance Company.* After summarizing the traditional rule that "the obligation to defend is measured by comparing the terms of the insurance policy with the pleadings of the claimants who sue the insured," the court restated the critical rule

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7. 3 Cal. App. 2d 624, 40 P.2d 311 (1935).
8. *Id.* at 630, 40 P.2d at 314.
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
14. *Id.* at 616, 29 Cal. Rptr. at 593.
that "the insurer's obligation to defend is one that must be determined before the outcome of the action against the assured, not thereafter." Any contrary rule would have the effect of wiping out all together the obligation to defend.

However, the court in the Maxon case again noted the limitation of the duty by stating that "the insurer is not required to defend an action against the insured when the complaint in that action shows on its face that the injury complained of is not only not covered by, but is excluded from the policy." Thus, the court refused to make the duty absolute and preserved the then existing exceptions.

THE GRAY CASE AND ITS PROGENIES

In the landmark case of Gray v. Zurich Insurance Co. the California Supreme Court re-examined the question of the duty to defend and, in the course of this examination, rejected the majority rule which required an insurer to defend any action against its insured in which the complaint showed on its face that the alleged injuries are within the terms of the policy coverage. In Gray, the California Supreme Court chose to set forth a new and more expansive view of the duty to defend holding that the "carrier must defend a suit which potentially seeks damages within the coverage of the policy." The language of the Gray case implies that the factors to be considered with regard to the duty to defend should include facts which the insurer learns from the insured as well as any facts ascertained from its own independent investigation and sources. The insurer, upon learning of these facts, has a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy.

The facts of the Gray case provide the background needed to more fully understand the court's rationale and eventual holding. It was an action by the insured against his insurer for failure to defend an action brought against the insured which stemmed from a complaint alleging that the insured had committed an assault. The underlying action arose when a Mr. Jones filed a complaint alleging that Dr. Gray "willfully, maliciously, brutally and intentionally" assaulted him. Dr. Gray then tendered the defense of the lawsuit to his insurer, Zurich Insurance Company, and requested that Zurich defend the tort action. Perhaps more importantly, Dr. Gray notified the company that he had

15. Id. at 617, 29 Cal. Rptr. at 594.
18. Id. at 275, 419 P.2d at 176, 54 Cal. Rptr. at 112.
19. Id.
20. Id.
acted in self-defense. Zurich Insurance Company refused to defend on the ground that the alleged intentional tort fell outside the policy coverage. Dr. Gray was unsuccessful in his defense on the self-defense theory and suffered a judgment of $6,000. He then brought an action against Zurich for failure to defend. The insurance policy issued to Dr. Gray by Zurich Insurance Company represented a comprehensive personal liability policy, including two endorsements:

1. To pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage; and
2. . . . to defend any suit against the insured alleging such bodily injury or property damaged in seeking damages which are payable under the terms of this endorsement, even if any of the allegations of the suit are groundless, false or fraudulent . . .

The court's rationale in concluding that Zurich's refusal to defend was a wrongful one was twofold. Initially, the Court determined that any ambiguity in the insurance policy and any doubts as to its meaning were to be resolved against the insurer and that this principle of interpretation takes on new meaning with regard to the doctrine of adhesion contracts. The court recognized that the contract was entered into between two parties of unequal bargaining strength and that the contract was offered to the weaker party on a "take it or leave it basis." Under this set of circumstances it was determined that the duty to defend, as set forth in the insurance policy, was a primary one and that the policy failed to clearly and in unambiguous terms indicate that the duty to defend would be subject to limitations based upon other exclusions in the policy. In other words, the court determined that the Zurich Insurance Policy, as written, did not in any way spell out that the duty to defend had any limitations upon it at all. Rather, the court found that it was a primary duty and was not co-extensive with its duty to indemnify the insured. The court then concluded that the reasonable expectation of a person reading such a policy would be to expect a defense by the insurer in all personal injury actions against him. This was because the relationship between the exclusionary clause with respect to the refusal to indemnify for intentional acts and the basic promise to defend was anything but clear.

The court's second stated rationale was that since modern procedural rules focus on the facts of the case rather than the theory of recovery

21. Id. at 267, 419 P.2d at 170, 54 Cal. Rptr. at 106.
22. Id.
23. Id. at 269, 419 P.2d at 171, 54 Cal. Rptr. at 107.
24. Id. at 273, 419 P.2d at 173-74, 54 Cal. Rptr. at 109-10.
25. Id.

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stated in the complaint, the duty to defend should be fixed by the facts which the insurer learns from the complaint, the insured and other sources.26

Under the new rule set forth in the Gray case, the insurance carrier must determine whether a potential of liability exists, and if so, a duty to defend arises. The language of the Gray case implies that this information may come from the insured, other sources, or the insurer's independent investigation.27 The test of "potential of liability" represented a radical departure from the traditional rule, but the court reasoned that the traditional rule that relied on pleadings was a dated one.28 This is particularly true in light of modem pleading rules that require notice pleading and provide for liberal rules of amendment. The facts of the Gray case stand as an excellent example of how the traditional rule with respect to the duty to defend based solely upon the pleadings would lead one to an improper result. In that case the pleadings indicated an intentional act by Dr. Gray, however, by way of affirmative defense Dr. Gray had pleaded that he had acted in self defense, thus negating the requirement of intent. Finally, although the court recognized that it was setting forth an expansive rule with respect to the duty to defend, it went to pains to indicate that the duty to defend was not absolute. For instance, it was concluded that "the insured would not expect a defense for an injury involving an automobile under a general comprehensive policy which excluded automobile coverage. We look to the nature and kind of risk covered by the policy as a limitation upon the duty to defend."29 This language negates claims made by some in the insurance industry that the duty to defend was made absolute by the Gray ruling.30 Instead, the rule is simply that the carrier must defend a suit which potentially seeks damages within the coverage of the policy, to the extent that the nature of the claim bears a reasonable relationship to the occurrence covered.

Therefore, the conclusion is unmistakable that the duty to defend, while not absolute, is broader than the duty to indemnify and in many cases, the duty to defend will arise even though there is no duty to indemnify.

In the years that followed the Gray decision, the appellate courts, while adhering to the principle enunciated in Gray, reiterated that there were in fact limitations upon the duty to defend. It was held, for exam-

26. Id. at 276, 419 P.2d at 176-77, 54 Cal. Rptr. at 113.
27. Id.
28. Id.
29. Id. at 275, 419 P.2d at 175, 54 Cal. Rptr. at 111.
ple, by the Third District Court of Appeal in *State Farm Mutual Automobile Insurance Co. v. Flynt*,\(^31\) that:

the 'groundless, false, or fraudulent' clause of an insurance contract does not extend the obligation to defend without limits, but includes only defenses to those actions of the nature and kind covered by the policy, and the allegations of a complaint filed by a third party against an insured are not determinative of the insurance company's obligation to defend the suit.\(^32\)

The court also recognized that an independent investigation by the carrier may lead it to the conclusion that potential liability does not exist even though the pleadings would suggest that a duty to defend existed. If this were true, the carrier might properly refuse to defend the suit.\(^33\) If the carrier refuses to defend, however, it does so at its own risk, and if it later develops that there is liability, or that potential liability existed under the policy, the company will be held accountable to its insured, or to one who obtained judgment against the insured in the action it refused to defend.\(^34\) In addition, the courts have recognized that the obligation to defend a lawsuit comes to an end where the liability phase of a bifurcated trial resulted in liability imposed solely with respect to matters not covered by a policy.\(^35\)

**Recent Developments**

In two very recent cases, *Giddings v. Industrial Indemnity Co.*\(^36\) and *Miller v. Elite Insurance Co.*\(^37\) the California courts re-examined the obligation of an insurance carrier to defend and shed light on the nature and extent of the duty to defend in the context of different factual circumstances.

The *Giddings* case, decided by the Fourth District Court of Appeal, arose as an action by the insureds against their insurers following a refusal by the insurers to defend the lawsuit. The issue involved "property damage" under liability insurance policies. The complaint filed against the insured alleged strictly economic losses such as lost profits, loss of good will, loss of anticipated benefit of a bargain, and loss of investment. The insurers took the position that such losses did not con-

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32. *Id.* at 548, 95 Cal. Rptr. at 302.
33. *Id.* at 549, 95 Cal. Rptr. at 302.
37. 100 Cal. App. 3d 739, 161 Cal. Rptr. 322 (1980).
stitute "property damage" under the liability insurance policy issued to the insured, and on this basis refused to defend the actions.

While the court in Giddings recognized that an insurer's duty to defend litigation brought against its insured is broader than its duty to indemnify and that the insurer must furnish a defense when it learns facts creating a potential of liability under the policy, it noted that the insured's obligation was not unlimited. It was held that the Giddings case was readily distinguishable from Gray and many of the cases following it, which have broadly interpreted the insurer's duty to defend. In the Gray case, the court noted that damage of the type covered by the policy had undisputably occurred, and the insurer relied on an unclear exclusionary clause in asserting it was not obligated to defend its insured.\(^{38}\) In the Giddings matter, on the other hand, the "question concerns the scope of basic coverage itself."\(^{39}\) After determining that strictly economic losses such as lost profits, loss of good will, loss of anticipated benefit of a bargain, and loss of an investment, did not constitute damage or injury to tangible property covered by a comprehen-sive general liability policy, the court concluded that the Giddings were entitled to a defense only if the third party's actions potentially sought recovery for damage to, or accidental loss of, use of tangible property.\(^{40}\) The court held that "no recovery and no duty to defend existed if the action potentially sought recovery only for damages to economic interests and property damage,"\(^{41}\) as such claims would constitute claims for damages of such a nature not potentially within the scope of the insurance coverage. While concluding that there was no duty to defend, the court nonetheless based its decision on the holding of the Gray case. The test remained that of the potential of liability under the policy.

In the case of Miller v. Elite Insurance Co.,\(^{42}\) the First District Court of Appeal held that the duty to defend had been violated where the carrier's denial of coverage was based upon ambiguous exclusionary language.\(^{43}\)

In the Miller case, the insured brought suit against his motorcycle liability insurer for breach of its obligation to defend, together with an action for breach of the implied covenant of good faith and fair dealing, regarding a claim brought against the insured for damages resulting from a fire that the insured accidentally caused while working on his motorcycle in the garage of the home that he was renting. The motor-

\(^{38}\) 112 Cal. App. 3d at 218, 169 Cal. Rptr. at 281.
\(^{39}\) Id.
\(^{40}\) Id. at 219, 169 Cal. Rptr. at 280.
\(^{41}\) Id.
\(^{42}\) 100 Cal. App. 3d 739, 161 Cal. Rptr. 322 (1980).
\(^{43}\) Id. at 752, 161 Cal. Rptr. at 329.
cycle liability insurance policy issued by Elite Insurance Company to Miller contained an exclusionary clause for destruction of property "rented to or in charge of the insured." The company took the position that the lawsuit filed against Miller for destruction of property was not one that "potentially seeks damages within the policy" by virtue of the exclusionary language, and thus no duty to defend arose.

The court concluded that a duty to defend existed under the circumstances of the case. The court first determined that the exclusionary clause that the company relied upon was not unambiguous. In the first place, the facts suggested that someone other than the insured was renting the premises, therefore making that portion of the exclusion inapplicable. Additionally, it was determined that "in charge of the insured" was ambiguous despite the fact that it virtually mirrored the language of California Insurance Code Section 11580.1(c) and (c)(6). The court noted that there was no indication whether any or all of the "property" referred to in the policy was real or personal property. The court concluded that no lay person could reasonably assume that the "property rented to or in charge of insured, referred to real property since it would seem applicable primarily to portable goods." For this reason, the exclusionary language was held to be ambiguous. Moreover, as the policy was written, the exclusionary clause was not presented in a conspicuous, clear and plain fashion so as to put the insured on notice of the exceptions of coverage.

After concluding that coverage under the policy existed, the court quite properly concluded that the company's refusal to defend was in fact a wrongful one. The court's reasoning began with a recognition that an insurer must defend a suit which potentially seeks damages within the coverage of the policy. If there is a doubt as to whether the insurer must defend, the doubt should be resolved in the insured's favor. Finally, the court reasoned that the insured's reasonable expectation in the purchase of the policy in question was that the insurer would cover damages caused by his motorcycle. The damage to the property was within the nature and kind of risk which Miller would have expected the policy to cover.

It is significant that the court noted that the insurance company had

44. Id.
45. Id.
46. Policy exclusionary language refers to "property owned or transported by the insured, or property rented to or in charge of the insured." Cal. Ins. Code §11580.1. The Insurance Code permits, in pertinent part, exclusions for "liability for damage to property owned, rented to, transported by, or in charge of, an insured." Id. §11580.1(c)(6).
47. 100 Cal. App. 3d at 757, 161 Cal. Rptr. at 329.
48. Id. at 753, 161 Cal. Rptr. at 330.
49. Id. at 756, 161 Cal. Rptr. at 331.
established a "reserve" fund for the defense of the Miller claims. The court found this to be an indication that the company perceived a possible duty to defend. Obviously, if the company believes that it has no duty to defend, then it would not establish a "reserve." To do so will undoubtedly prejudice its position in any subsequent litigation involving its duty to defend. The court also noted that the company had taken another step that indicated it felt a possible duty to defend. In the course of handling the claim the insurance company had presented an offer of a compromised settlement. This was treated by the court as evidence that Elite had indeed perceived a possible duty to defend. 50

The courts in both the Giddings and Miller cases have reasserted that the insurer must defend a suit which potentially seeks damages within the coverage of the policy. However, both cases illustrate, and particularly the Miller case illustrates, that the test to be applied by a carrier with regard to the duty to defend must be viewed with an eye towards protecting the reasonable expectation of the insured.

The Miller case is also noteworthy in illustrating that a violation of the duty to defend will often give rise to a claim that the insurance company violated the covenant of good faith and fair dealing implied by law in all insurance contracts, thus exposing the insurer to punitive damages. 51 The courts have imposed upon insurance companies an implied duty of good faith and fair dealing in the negotiation and settlement phases of insurance cases. 52 Good faith and fair dealing means that each party is prevented from interfering with the other's right to benefit from the contract. 53 Therefore, an insurance company that wrongfully refuses to defend its insured must recognize that in wrongfully refusing to defend the company may violate its obligation of protecting the interests of the insured equally with its own, thus giving rise to a claim for breach of the covenant of good faith and fair dealing. Such a claim may well expose an insurance company to a punitive damage award, or require the payment of a verdict in excess of the policy limits. 54

CONSEQUENCES OF WRONGFUL REFUSAL TO DEFEND

The insurer has no liability when it has made a proper refusal to defend its insured. However, when the refusal to defend is determined to be a "wrongful" refusal, the insurance carrier is liable for all dam-

50. Id. at 754, 161 Cal. Rptr. at 330.
53. 100 Cal. App. 3d at 756, 161 Cal. Rptr. at 332.
54. Id.
ages proximately caused by the insurer’s wrongful act. It was determined in Arenson v. National Automobile and Casualty Insurance Co. that an insurer’s unwarranted refusal to defend a suit against the insured relieves the insured from his contractual obligation to surrender control of such lawsuit to the insurer, and therefore allows him to defend the suit as he sees fit including choosing his own counsel. “Where the insured is thus compelled to conduct his own defense, he may recover the expenses of litigation including costs and attorney’s fees from the insurer.” This is so even though the insured’s defense is unsuccessful. Furthermore, the insured can recover the expenses of an appeal in the event the grounds for appeal are reasonable, even if the appeal is unsuccessful. In addition to the above costs and expenses, it was held in the Gray case that the insurer who wrongfully refused to defend is generally liable on the judgment against the insured even when that judgment exceeds the policy limits.

In holding that the insurer who wrongfully refuses to defend is generally liable on the judgment against the insured, the Gray court applied the contract theory of recovery that had previously been upheld in Tomerlin v. Canadian Indemnity Co. The Tomerlin case held that the wrongful refusal to defend an action on the part of the insurance company constituted a breach of the insurance contract. The court in Tomerlin specifically rejected a theory presented to it that the breach of the duty to defend sounded in tort rather than contract. In reaching its conclusion the court reasoned that the tort theory would “inequitably frustrate plaintiff’s recovery” and that it would impose upon him the burden of providing the precise extent of the loss caused by the withdrawal of the insurer’s attorney from a suit against the insured. The court held, therefore, that the wrongful failure to defend opens the insurance carrier to liability for the whole amount of the judgment including any amount in excess of the policy limits.

In addition, by refusing to defend an action, the insurer should recognize that by its actions it loses control of the defense of the litigation. Once the insurer refuses to defend the suit, the insured is no longer obligated under the contract to leave the management of the lawsuit to the insurer. This, in turn, takes from the insurer the opportunity to

56. Id. at 537, 310 P.2d at 967.
57. Id.
58. Id. at 539, 310 P.2d at 968.
59. Id. at 536, 310 P.2d at 967.
62. Id. at 649-50, 394 P.2d at 571, 30 Cal. Rptr. at 731.
63. 45 Cal. 2d at 84, 286 P.2d at 816.
control the course of the action, and, quite likely, takes away the opportunity to settle the case at a greatly reduced amount, thereby avoiding the significant damages imposed on the insurance carrier for a wrongful refusal to defend.

As a further, and perhaps more significant, item of damage imposed for the wrongful refusal to defend, the courts have held that under the appropriate factual circumstances an insurer who breaches the duty to defend may be held liable for damages for pain and emotional distress caused to its insured.64 The courts have recognized the “damages for breach of the duty to defend are not inexorably imprisoned within the policy limits, but are measured by the consequences proximately caused by the breach.”65 While recognizing the traditional rule that the insurer’s liability is generally limited to the amount of the judgment, the courts have held that where the damages proximately resulted from the breach can be shown to include damages to the insured’s comfort, happiness, health and welfare, recovery will be permitted for the physical suffering caused by the breach.66 Therefore, in addition to exposing the insurance company to liability for the whole amount of the judgment, its actions may very well expose it to liability for damages for pain and emotional distress caused to its insured.

PROPER APPROACH FOR INSURANCE COMPANIES, THEIR PERSONNEL AND ATTORNEYS

By stating that the duty to defend arises at the pre-litigation stage of a claim, the courts have served notice to the insurance industry that the question of the duty to defend must be addressed immediately upon receipt of notice of the claim. Therefore, as soon as the insurance carrier (hereinafter referred to as “Company”) receives notice that a claim is being presented against its insured that “potentially” seeks damages within coverage of the policy, the Company must undertake to defend that claim including an investigation and evaluation.67 The Company is not justified in waiting until a lawsuit has been filed before undertaking its duty to defend as such action would be contrary to the holding that the duty to defend applies equally to the pre-litigation and litigation stages of a claim.68 Therefore, upon receiving notice of a claim the Company should immediately undertake to determine whether or not the claim seeks dam-

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65. Id. at 530, 88 Cal. Rptr. at 259.
66. Id. at 528, 88 Cal. Rptr. at 258.
ages that "potentially" fall within the insurance coverage offered to its insured. From the earlier discussion, it is apparent that such determination cannot be made from the complaint alone.69

In short, it is encumbent upon the Company's personnel to make a benefits v. risks determination as to how to proceed. The "benefits" referred to are the savings in legal and other loss expenses. The "risks" referred to are: (1) loss of control of the defense of the action; (2) liability for the expenses incurred by the insured in defending the litigation; (3) liability on the judgment eventually obtained regardless of the amount of the policy limits; and (4) possible liability to the insured for damages on account of emotional distress. These substantial risks and unfortunate consequences, as discussed earlier, may well dictate that the risks be found to outweigh the benefits. Of course, if benefits and risks are weighed at the pre-litigation stage, in keeping with the dictates of the Miller decision, then the Company may avail itself of a declaratory relief action with every opportunity to have its obligations, if any, adjudicated long before the potential underlying action is tried.70

Under these circumstances, many of the consequences of a bad faith refusal can be avoided in the event that the court enters a declaratory order adverse to the Company. In particular, the Company will avoid liability in excess of policy limits. Furthermore, by seeking declaratory relief at the pre-litigation stage, the Company can avoid the large expenditures of providing a defense pursuant to a reservation of rights. Obviously, if the declaratory relief action proceeds soon after the first notice of the claim but before commencement of litigation by the plaintiff, defense costs would be kept at a minimum since the plaintiff's action should not have proceeded beyond the preliminary stages. Hence, the Company is able to minimize its risks and defense costs when it acts promptly to ascertain its obligation to defend the insured. This is true even if the Company loses the declaratory relief action. The Company will be able to step in and defend the action and will, therefore, be able to control its course. The maximum exposure the Company thereafter faces when following an approach of this sort will be the policy limits and, clearly, it has the opportunity to settle the action within the policy limits when possible. Moreover, by seeking declaratory relief early in the claim, the Company avoids the spectre of a subsequent action by the insured alleging bad faith on the part of the insurer. In the long run, therefore, the Company will experience substantial monetary savings.

69. Id.
70. Declaratory relief actions are entitled to a trial setting preference in California. CAL. CIV. PROC. CODE §1062(a).
Clearly, in fact, there may be doubtful situations where the benefits v. risks determination might be difficult. Of course, the determination of benefits and risks must be made in keeping with the duties placed upon the Company by virtue of Insurance Code Section 790.03(h)(1)-(15), more commonly known as the Unfair Claims Practice Act. While it must recognize its duties in this regard, the Company should not adopt a policy of providing a defense whenever called upon. It is suggested that the company adopt a specific procedure, such as the following, so as to lead to the avoidance of unnecessary risks which are the obvious consequence of an improper refusal to defend.

DOES THE COMPANY HAVE THE DUTY TO DEFEND?

A. With Notice of Claim before Litigation

When the Company receives notice of the claim prior to the filing of an action by the injured party, it should undertake the following procedures.

First, the Company should obtain basic information with regard to the nature of the subject claim and the damages allegedly suffered. This information should come from the insured, the injured party, the Company's own sources and the Company's investigation of the claim.

Second, it should review the coverage provisions of the subject policy to determine whether or not the subject claim is either “not covered” or “excluded” by a specific provision in that policy.

If the claim is “not covered” by the policy, then it is up to the Company to notify its insured and the claimant or, claimant's counsel, in writing within a reasonable time to the effect that the Company will not defend if suit is filed nor will it indemnify the insured if a judgment is rendered; the notice should state the reason for the refusal.

If, upon receipt of the notice, the insured fails to agree or questions this determination in any way, the Company should obtain counsel for the filing of a declaratory relief action to determine its obligations under the policy. Counsel should be requested to proceed to trial as quickly as possible.

If on the other hand the subject claim is “excluded” under the policy, the following steps should be taken.

Initially, the Company should seek the written opinion of counsel with respect to whether or not the subject exclusion is sufficiently unambiguous so as to permit a refusal to defend despite the various tests.

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71. The Unfair Claims Practises Act is beyond the scope of this article. See Royal Globe Ins. Co. v. Superior Court, 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979).
as set forth in *Gray v. Zurich Insurance Co.*\(^{72}\)

Next, advise the insured in writing that such opinion has been sought and advise the insured as to the opinion given.

If an opinion favorable to the insurer is given, the Company should file a declaratory relief action to establish that the Company has no duty to defend if any objection on the part of the insured is received. If counsel's opinion is favorable to the insured, the Company must prepare to defend and indemnify.

**B. With Complaint Filed Prior to Notice**

When a Complaint has been filed before a determination has been made with regard to the duty to defend, then the following steps should be taken.

First, the Company needs to obtain basic information with regard to the nature of the subject claim and the damages allegedly suffered. It should review the allegations of the Complaint and make an independent investigation of the facts. If any theory or cause of action is covered by the subject policy, then a defense is owed to the insured. Second, the Company should proceed as outlined above to analyze the policy exclusions and areas of noncoverage recognizing that the Company should defend under a reservation of rights where it is relying on an exclusion.

While construing the insurance contract so as to protect the insured's reasonable expectation, the carrier should recognize that if there is a real doubt as to whether the Company must defend, the doubt should be resolved in the insured's favor.*\(^{73}\)

Once it is determined that the claim does seek damages which potentially fall within the insurance coverage, the Company should immediately tender to the insured a complete defense. Once the Company has tendered a defense, it must act in utmost good faith to protect the interests of its insured equally with its own.*\(^{74}\)

Unfortunately, the courts have not offered clear standards which may be used in determining whether the duty to defend is present so as to provide a simple answer to each and every factual situation. Thus, there are situations in which the Company may choose to defend the insured even though coverage has not been determined. The Company should, in such a situation, proceed under a reservation of rights. In

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\(^{72}\) See 100 Cal. App. 3d at 753, 161 Cal. Rptr. at 330. See text accompanying notes 23-30 *supra.*

\(^{73}\) 100 Cal. App. 3d at 757, 161 Cal. Rptr. at 331.

\(^{74}\) *Id.*
any instance where the Company reserves its rights it should do so by a letter to the insured which meets the following standards.

The reservation of rights letter, in order to be effective, must be specific and clear enough to give the insured notice of the potential coverage problems. It must be sent as soon as reasonably possible in order to avoid a waiver and estoppel situation. If the reservation of rights letter is sent in a timely manner, the Company may undertake the defense of the action and the insured may not successfully raise the claim that the insurer has waived its right to assert a defense that the claim is not covered or excluded.\(^7\)

Attention to the suggested approach should in fact amount to substantial savings to the Company. It is submitted that the costs of making the “benefits versus risks” determination suggested in the approach, including the expenses incurred with counsel for opinions and for the prosecution of declaratory relief actions, are substantially smaller than the costs which would be incurred were the Company to simply adopt a policy of defending the insured in almost any situation. As mentioned earlier, particular benefits may well flow to the Company in those cases where it has notice of the claim prior to the institution of litigation. However, even in those instances where litigation has been instituted before the Company receives first notice of the claim, it nevertheless stands to minimize its loss expense and indemnity expense if it acts promptly by defending under a reservation of rights or by pursuing a declaratory relief action. While great care must be taken in analyzing the benefits and the risks involved, the savings in doing so properly will well reward the effort.

**CONCLUSION**

The courts have made both the obligations and risks with regard to the duty to defend clear and concise. Therefore, the Company should recognize its obligations to make a determination as to both coverage and defense and should do so promptly, thoroughly and in utmost good faith. The Company must be aware of the consequences of its wrongful refusal to perform its duty to defend. Hopefully the discussion in the earlier portion of this article sheds light on the risks involved when the carrier wrongfully refuses to defend an action. While the duty to defend will most likely remain a frequent source of litigation in California, it is the hope of these writers that the approach presented in this article shall be of help to the insurance industry in resolving the day to day problems which arise in conjunction with this duty. Careful analysis under this approach should eliminate a wrongful refusal problem and the subsequent financial loss.

\(^7\) Id. at 755, 161 Cal. Rptr. at 330. For a discussion of reservation of rights letters see Comment, Reservation of Rights Notices and Nonwaiver Agreements, 12 Pac. L.J. 763-86 (1981).