

Client Alert

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Carrier Cannot Rely On California Statute To Limit Attorney Rates Retroactively

In December 2014, in *City Art, Inc. et al. v. Superior Court (Travelers Property Casualty Co. of America)*, Case No. B256132, the California Court of Appeal, Second Appellate District (“Court”) ruled, in an unpublished opinion, that Travelers cannot retroactively apply California’s statutory rate limitations to attorneys’ fees that its policyholder incurred before Travelers assumed payment of the policyholder’s independent counsel’s fees. In so holding, the Court confirmed the longstanding rule in California that a carrier who breaches the duty to defend is liable for the reasonable attorney fees incurred by the policyholder and cannot rely on the statutory rate limitation afforded under California Civil Code Section 2860.

Background

On May 4, 2007, City Art, Inc., the policyholder, was sued by DK Art Publishing, Inc., in a wide-ranging complaint alleging 20 causes of action involving thousands of art pieces that allegedly were lost, damaged or destroyed while in City Art’s custody. When City Art tendered the complaint, Travelers declined the tender, raising an exclusion for damage to personal property in the care, custody or control of City Art, as well as Travelers’ analysis that the cause of action for trade libel did not qualify as a covered claim.

City Art defended itself against the claims by DK Art, while attempting to convince Travelers to reconsider its denial of coverage. In April 2009, two years after the original complaint was filed, City Art suggested to Travelers that the art at issue in the litigation had not been in City Art’s exclusive care, custody or control, and backed up those claims with specific examples. After exchanging further correspondence with City Art, Travelers, on February 12, 2010, stated that, based on the new information provided, Travelers would “agree to participate in the defense of [City Art], pursuant to a full reservation of rights,” and would pay defense fees dating back to April 2009, the date that Travelers first received extrinsic evidence that triggered a duty to defend. Travelers refused to pay the fees of independent counsel incurred by City Art prior to April 2009.

City Art eventually filed an action against Travelers for breach of contract, bad faith and declaratory relief, claiming that Travelers was obligated to pay the reasonable and necessary fees and costs incurred by City Art’s independent counsel and Travelers’ obligation is not subject to the rate limitation of Civil Code Section 2860 until such time as Travelers starts adequately funding the defense of the lawsuit brought by DK Art.

Court’s Ruling

The Court analyzed whether Travelers, which initially denied a duty to defend but eventually agreed to do so by means of paying the fees of independent counsel selected by City Art, could take *retroactive* advantage of the rate limitations set forth in Civil Code Section 2860. The Court held that Travelers could not rely on Section 2860 to limit rates retroactively, as Section 2860 applies only when Travelers satisfies its duty to defend.

The rate limitations of Section 2860 provide that “the insurer’s obligation to pay fees to the independent counsel selected by the insured 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.” See California Civil Code § 2860(c). The Court held that Travelers could not rely on this statute to limit its obligation to City Art’s independent counsel’s fees until Travelers could show that it was timely satisfying its duty to defend. In other words, when Travelers initially denied coverage to City Art, Travelers was not honoring its duty to defend and, therefore, could not rely on Section 2860 to limit the rates incurred by independent counsel during that period. Travelers could rely on the limitations of Section 2860 only after it acknowledged and conceded that it had a duty to defend.

Relying on other precedent and the language of Civil Code Section 2860, the Court held that Section 2860’s rate limitation cannot apply retroactively to attorney fees incurred prior to the time Travelers began paying defense costs. As the Court explained, “as a general rule, an insurer who breaches the duty to defend is liable for the reasonable attorney fees incurred by the insured in obtaining a defense. ... If an insurer could retroactively rely on section 2860, an insurer that breached the duty to defend could reduce the damages it owed simply by establishing that it also breached the duty to provide independent counsel. This is nonsensical.”

Implications

The *City Art* decision confirms the rule in California that when a carrier breaches the duty to defend, and its obligation to pay defense costs would have otherwise been limited by Civil Code Section 2860, the Section 2860 limitation does not apply to the attorneys’ fees the carrier failed to pay. Instead, the carrier must pay the usual measure of damages for breach of the duty to defend, which generally is the reasonable and necessary attorney fees actually incurred by the policyholder in obtaining a defense. The *City Art* decision is consistent with prior appellate court precedent set forth in *Janopaul + Block Companies, LLC v. Superior Court* (2011) 200 Cal.App.4th 1239 and *Intergulf Development LLC v. Superior Court* (2010) 183 Cal.App.4th 16.

City Art is also a reminder that policyholders should reject a carrier’s attempt to limit the rates that the carrier is obligated to pay by trying to compel arbitration pursuant to Civil Code Section 2860(c) before a court determines, in the first instance, whether the carrier breached its duty to defend. Civil Code Section 2860 makes clear that the protections afforded by this statute apply only when a defense is being provided by the carrier. As such, if the policyholder can show that the carrier breached its duty to defend, the rate limitations of Section 2860 will not apply.

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