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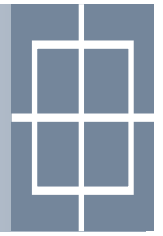
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If you are interested in receiving *Insurance Coverage & Bad Faith Quarterly Report*, or have someone to whom you would like it sent, call (661) 322-3051, ext. 184 and request your free copy.

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INSURANCE CARRIER BUT NOT INSURANCE BROKER LIABLE UNDER STIPULATED JUDGMENT

by Rocky K. Copley

Most liability insurance policies provide that the insurance carrier will defend, as well as indemnify, its insured subject to the terms and conditions of the insurance policy. The duty to defend is a separate and independent duty from the duty to indemnify. The duty to defend is determined at the beginning of the lawsuit, whereas the duty to indemnify is determined at the conclusion.

Insurance carriers are frequently faced with difficult decisions on whether to defend a lawsuit brought against a policyholder when the complaint contains several theories and/or elements of requested damages which are not covered under the liability insurance policy. If the claims asserted in the underlying complaint raise a "potential for coverage," an insurance company has a duty to provide a defense to its insured upon the tender of those claims, until such time as the insurance company can produce undisputed evidence which *conclusively establishes* that there is no "potential for coverage."

When facing coverage issues, a liability insurance carrier has basically three options. It may (1) defend the action under a reservation of rights; (2) file a separate declaratory relief action requesting the court to declare that it has no obligation to defend or indemnify its insured; or (3) it may simply deny the request for coverage and take its chances that the trier of fact in an action alleging bad-faith breach of the contractual duty to defend will agree that no defense was owed.

An insurance carrier who chooses to simply deny coverage or a defense to its insured runs a significant risk. When an insurer wrongfully refuses to defend, the insured is relieved of the obligation to allow the insurer to manage the litigation and may proceed in whatever

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Rocky K. Copley



Rocky K. Copley is the Managing Partner of Borton, Petrini & Conron, LLP's San Diego office. He received his undergraduate degree from the College of William and Mary and his J.D. from McGeorge School of Law.

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Coverage Exclusions Unenforceable Without Notice to Insured

by Rocky K. Copley

It is the general rule that a party is bound by contract provisions and cannot complain of unfamiliarity with the language of the contract. An insured has a duty to read his policy and that general rule applies even though an insured may not fully understand all of the terms of the policy. However, the duty to read a policy is insufficient to bind an insured to unusual or unfair language unless it is brought to the attention of the insured and explained.

It has been a long-standing general principle applicable to insurance policies that where greater coverage is provided in an earlier policy, a renewal policy which contains new or added exclusions or limitations requires the carrier to notify the insured of the specific reduction in coverage. Where an insured could reasonably expect to be covered for a particular loss, exceptions and limitations of coverage must be called to the insured's attention

clearly and plainly before the exclusion will be interpreted in a manner to relieve the insurer of liability under the policy. Renewal insurance policies frequently will contain new exclusions or different terms. The new exclusions or different terms are typically brought about when insurance carriers decide to address certain types of claims or losses that were unexpected when the earlier policies were sold. However, if the new terms of the renewal policy act to provide new exclusions or limitations of coverage, such

new exclusions and limitations must be brought to the attention of the insured in order to be enforceable. Frequently, insurance carriers will simply send a separate notice stating "Important Notice" and warn the insured that there are new exclusions in the policy and recommend the insured read the exclusions. The courts have held that giving a general warning to the insured to read the policy because there are new terms or exclusions, is insufficient to provide the requisite notice.

Insureds should be aware that they should pay special attention to the carrier's attempt to enforce exclusions in situations where the insured has been covered by the same insurance company for two or more years. A careful reading must be made of the original policy to determine if the claim would have been covered under the original policy. If coverage would have been provided, the analysis must then extend to whether the subsequent policies would provide coverage. If the subsequent policies exclude coverage because of a new exclusion or limitation of coverage, careful analysis must be made to determine whether the carrier provided notice of the new exclusion or limitation of

coverage when the policy was renewed. If the requisite notice and explanation of the new exclusion or limitation of coverage was not provided, the court will not enforce the exclusion or limitation. In order for an exclusion to be enforced, the exclusion must be "clear, conspicuous and unambiguous." California courts have stated that an exclusion contained in a policy that the insured has never seen provides no notice, let alone the "clear and plain notice" required by law in the area of insurance contracts.

Consequently, an insured is advised to keep all correspondence and notices that accompany the insurance policies in situations where the policies are renewed. Furthermore, copies of the application for any renewal should also be preserved. These documents could provide evidence that no notice was ever given

of the new exclusion or limitation of coverage that the carrier is now attempting to enforce.

Insurance carriers would be well-advised to work carefully with appropriate insurance coverage counsel to draft an appropriate notice to accompany any new exclusions to their standard insurance policies in order to provide the "clear and



"The duty to read a policy is insufficient to bind an insured to unusual or unfair language unless it is brought to the attention of the insured and explained."

plain notice" of new exclusions or limitations of coverage to the insured when the insured decides to renew the insurance policy with the carrier. Without the required clear and plain notice, a carrier will be unable to enforce the exclusions or limitations of coverage that were inserted in the renewal policy.



INSURANCE CARRIER BUT NOT INSURANCE BROKER
LIABLE UNDER STIPULATED JUDGMENT*continued from page 1*

manner is deemed appropriate. Frequently, insurance carriers conduct little independent investigation before deciding to deny its insured a defense. The ultimate determination as to whether or not there was a duty to defend will be based upon the facts known by the insurer, both from the allegations of the face of the third-party complaint, as well as from extrinsic information, that were reasonably available to the insurer if it had conducted an investigation. The risk that an insurer takes when it denies coverage without investigating the claim is that the insured may later be able to prove that a reasonable investigation would have uncovered evidence to establish coverage or a potential for coverage. In that case, the insurer will be liable for the costs of defense already incurred by the insured and could also be exposed to tort liability for breach of the implied covenant of good faith and fair dealing.

Insureds faced with the situation of denial of a defense by their insurance carrier may proceed to trial or negotiate the best settlement possible with the plaintiff and thereafter seek recovery for their defense costs and any monies paid to the plaintiff. However, insureds are not always in a financial position to fund a defense or a settlement. In those situations, insureds frequently negotiate a settlement with a plaintiff wherein a stipulated judgment is agreed to. The plaintiff takes an assignment of rights and agrees that the judgment will not be enforced against the insured and that the plaintiff will seek payment and satisfaction of the judgment solely from the insurance carrier. This is generally referred to as a stipulated judgment with a covenant not to execute. This procedure has been upheld many times by California courts. Where an insurance company breached its duty to defend and a judgment was entered against the insured, the insurance company will be bound by the terms of that judgment absent fraud or collusion. In other words, the third-party claimant suing on the stipulated judgment need only prove breach of a duty to defend or that coverage existed or potentially existed under the policy. Once that has occurred, the prior stipulated judgment is considered conclusive on the issues of the liability of the insured to the injured third party and the amount of the damages.

Where a stipulated judgment is agreed to, coupled with a covenant not to execute, the courts recognize that there is a high potential “for fraud or collusion.” Consequently, the courts have stated that in situations where a settlement of a stipulated judgment with a covenant not to execute the judgment is entered against the insured, such a settlement will raise only an evidentiary presumption in favor of the insured (or the insured’s assignee) with respect to the existence and the amount of the insured’s liability. The effect of such a presumption is to simply shift the burden of proof to the insurer to prove that the settlement was unreasonable

or the product of fraud or collusion. If the insurance carrier is unable to meet that burden of proof, the stipulated judgment will be binding upon the insured. Furthermore, where the insurer has been notified of an action and refuses to defend on the ground that the alleged claim is not within the policy coverage, it is bound to the judgment even though the judgment was rendered on a legal theory not within the policy coverage. In other words, if one theory potentially would have been covered, the insurance carrier is liable for the entire stipulated judgment even though it is based upon a legal theory not covered by its policy. Consequently, liability insurance carriers should be highly motivated to carefully evaluate coverage issues when determining whether or not to provide a defense or coverage for a third-party claim.

While the case law has repeatedly upheld an insured’s right to enter into a stipulated judgment with a covenant not to execute, the courts have imposed limitations. First, where the insurance

carrier is providing a defense under a reservation of rights or is otherwise defending and refuses a policy limits demand, the insured cannot simply negotiate a settlement with the plaintiff and have a judgment entered by way of a stipulation. Furthermore, if a stipulated judgment is entered and it is later determined that the insurance carrier erroneously denied coverage, the stipulated judgment is enforceable against the insurance carrier. However, it is not binding upon the insurance broker that procured the insurance policy. In the recent case of *Valentine v. Membrita Insurance Services*, the Court of Appeal rejected the plaintiff’s request to make an insurance broker bound to a stipulated judgment. The court pointed out that there are special duties imposed upon insurance carriers

because of the unequal bargaining strength of the parties in the relationship. However, the same cannot be said of the relative bargaining strength between a broker and its clients. Sometimes, clients may be more knowledgeable and sophisticated than the broker in specialized areas of commercial insurance. A settlement by way of a stipulated judgment, coupled with a covenant not to execute, provides no reliable basis to establish damages caused by an insurance broker.

In conclusion, California courts continue to hold that an insurance company acts at its own risk when it refuses to defend a third-party claim based upon coverage grounds. Insurance carriers can be held liable for a stipulated judgment so long as there was a “potential for coverage” under the subject insurance policy. In contrast, no similar risk appears to apply to insurance brokers who procure insurance. Stipulated judgments with covenants not to execute will not be similarly enforced against the insurance broker. The broker is not bound by the stipulated judgment if there was a potential for coverage. An insured and/or third-party creditor by way of the stipulated judgment must continue to establish negligence and damages caused by the conduct of the broker and the stipulated judgment will not satisfy those elements. ❖

An insurance carrier who chooses to simply deny coverage or a defense to its insured runs a significant risk.

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