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SIGNATURE RESOLUTION

Journal of Consumer Attorneys Associations for Southern California
ADVOCATE
September 2019 Issue

Insurance issues in settlement discussions

A REVIEW OF THE INSURER'S DUTY TO SETTLE AND THE EFFECT OF MEDIATION CONFIDENTIALITY LAWS ON MEDIATED SETTLEMENTS

So, it's time to try to settle a lawsuit? Where does an insurer fit in the process? Does it matter whether it's an informal discussion, a settlement conference, or a mediation? The answers to these questions can determine how and whether lawsuits get settled. The answers aren't always as simple as they might seem. Indeed, insurance coverage issues – couched in reservations of rights, disputes over covered and uncovered claims, who controls what, and how to ensure that there's an appropriate "record" of settlement communications – are becoming more prevalent as time passes.

Here are five key issues – and suggestions to help get lawsuits settled while minimizing coverage disputes.

An insurer's duty to settle

One of the benefits of liability insurance is, of course, the fact that an insurer has a duty to fund reasonable settlements of lawsuits against its insured – at least if those lawsuits are potentially covered. The exact contours of the insurer's duty to settle are fairly well defined now and have been since the California Supreme Court's landmark decision in *Comunale v. Traders & General Insurance Co*. (1958) 50 Cal.2d 654. There, the court stated, "the implied obligation of good faith and fair dealing requires the insurer to settle in an appropriate case although the express terms of the policy do not impose such a duty." (*Id.* at p. 659.) "The duty to settle is implied in law to protect the insured from exposure to liability in excess of coverage as a result of the insurer's gamble – on which only the insured might lose." (*Murphy v. Allstate Ins. Co*. (1976) 17 Cal.3d 937, 941.)

> [I]f an insurer fails to accept a reasonable settlement offer within the policy limits, and the judgment exceeds the policy limits, the insurer risks liability for the entire judgment and any other damages incurred by the insured. Moreover, the insurer may not consider the issue of coverage in determining whether the settlement is reasonable.

(*Blue Ridge Ins. Co. v. Jacobsen* (2001) 25 Cal.4th 489, 502.)

Howard v. American Nat'l Fire Ins. Co. (2010) 187 Cal.App.4th 498, illustrates how these principles apply. In *Howard*, the court recognized that "an insurer may reasonably underestimate the value of a case, and thus refuse settlement," but "does not act reasonably if it uses its no-coverage position to refuse settlement altogether." (*Id.* at p. 529.) It stated that "it has never been held that an insurer in a third party case may rely on a genuine dispute over coverage to refuse settlement. Instead, it is a long-standing rule that 'the only permissible consideration in evaluating the reasonableness of the settlement offer becomes whether, in light of the victim's injuries and the probable liability of the insured, the ultimate judgment is likely to exceed the amount of the settlement offer.'" (*Id.* at p. 530.)

The *Howard* court also addressed an insurer's duty to settle when a settlement was possible within the combined limits of multiple policies, but not the limit of any one policy. "That fact is relevant in evaluating whether an insurer, in a multiple-insurer case, had an opportunity to settle. When multiple insurance policies provide coverage, each insurer's obligation is to cover the full extent of the insured's liability up to policy limits." (*Id.* at p. 525.) The court emphasized that the law "cannot excuse one insurer for refusing to tender its policy limits simply because other insurers likewise acted in bad faith.

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If this were not the case, insurers on the risk could simply all act in bad faith, thus immunizing themselves from bad faith liability." (*Ibid.*)

The cooperation condition

Most insurance policies include a condition commonly referred to as a "cooperation" condition. It typically states:

> You and any other involved insured must … Cooperate with us in the investigation or settlement of the claim or defense against the "suit" . . . .

(Commercial General Liability Coverage Form § IV.2.c(3) (Insurance Services Office, Inc. 2012).)

Generally speaking, an insurer "may assert defenses based upon a breach by the insured of a condition of the policy such as a cooperation clause, but the breach cannot be a valid defense unless the insurer was substantially prejudiced thereby." (*Campbell v. Allstate Ins. Co*. (1963) 60 Cal.2d 303, 305 ["[P]rejudice is not shown simply by displaying end results; the probability that such results could or would have been avoided absent the claimed default or error must also be explored."]; *Clemmer v. Hartford Ins. Co*. (1978) 22 Cal.3d 865, 883 n.12.) As one court held, "an insurer, in order to establish it was prejudiced by the failure of the insured to cooperate in his defense, must establish at the very least that if the cooperation clause had not been breached there was a substantial likelihood the trier of fact would have found in the insured's favor." (*Billington v. Interins. Exch. of S. Cal*. (1969) 71 Cal.2d 728, 737.) However, if the insurer establishes such prejudice, then it may be excused from its duty to fund a settlement, at least to the extent of its prejudice.

Thus, an insured should use reasonable efforts to cooperate with an insurer, both to provide information that the insurer may legitimately need and to avoid a coverage dispute.

The consent condition

Most insurance policies also have a condition referred to as a "voluntary payments" or "consent" condition. One common version states:

> No insured will, except at that insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.

(Commercial General Liability Coverage Form § IV.2.d (Insurance Services Office, Inc. 2012).)

While an insurer generally may rely on non-satisfaction of a condition as a coverage defense only if it has been prejudiced by the non-satisfaction, the standard is different as to the consent condition. In fact, an insurer may be able to escape a duty to pay for a settlement if the insured agrees to it without the insurer's consent. As one court observed:

> Ours is the rare case where the insured tenders the defense and *then* negotiates a settlement on its own, leaving the insurer in the dark. . . . [W]e find no case holding that a *post* tender breach of [a consent] provision is unenforceable. Indeed, language from a leading Supreme Court decision indicates that such a provision *is* enforceable posttender until the insurer wrongfully denies tender.

(*Low v. Golden Eagle Ins. Co*. (2003) 110 Cal.App.4th 1532, 1546-47.)

However, an insurer might not be able to assert an insured's failure to satisfy a consent condition as a valid coverage defense when it has reserved rights or denied coverage. As one court explained, "an insurer is not allowed to rely on an insured's failure to perform a condition of a policy when the insurer has denied coverage because the insurer has, by denying coverage, demonstrated performance of the condition would not have altered its response to the claim." (*Select Ins. Co. v. Superior Court* (1990) 226 Cal.App.3d 631, 637. See also *Jamestown Builders, Inc. v. Gen. Star Indem. Co.* (1999) 77 Cal.App.4th 341, 347-48 ["The no-voluntary-payments provision is superseded by an insurer's antecedent breach of its coverage obligation."].) Indeed, consent conditions are only enforceable in the absence of insurer breach. (*Low, supra,* 110 Cal.App.4th at p. 1544. See *Samson v. Transamerica Ins. Co*. (1981) 30 Cal.3d 220, 238 ["[I]f an insurer denies coverage to the insured, the . . . insured is relieved of his obligation to inform the insurance company of the service of summons or the date of trial of the action."]; *Nat'l Steel Corp. v. Golden Eagle Ins. Co*. (9th Cir. 1997) 121 F.3d 496, 501 ["where an insurer improperly refuses to defend an insured, the insured is entitled to make a reasonable settlement of the claim in good faith, and then maintain an action against the insurer to recover the amount of the settlement"].)

Even if an insurer offers to fund part of a reasonable settlement, "the insured may conclude a favorable settlement by contributing the deficit itself and, assuming the insurer's breach can be proven, recover the payment in a subsequent action for breach of the covenant of good faith and fair dealing." (*Hamilton v. Maryland Cas. Co*. (2002) 27 Cal.4th 718, 732.)

If an insurer has not breached or refused to defend, an insured still might have a right to settle without its insurer's express consent. As a California court of appeal held:

> [E]ven if the insurer has not denied coverage or refused to defend, the insurer has a duty to accept a reasonable settlement, and the insurer's refusal to settle may give rise to the insured's action for reimbursement of the settlement. . . . In such a case, the insured has the burden of showing the settlement was reasonable and if it meets that burden, then again the act of settlement raises two presumptions: that the claim was legitimate and that the amount of the settlement was the amount of the insured's liability.

(*Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co*. (1996) 45 Cal.App.4th 1, 85.)

Indeed, "where – because of the insurer's reservation of rights based on possible noncoverage under the policy – the interests of the insurer and the insured diverge, the insurer must pay reasonable costs for retaining independent counsel by the insured." (*Hartford Cas. Ins. Co. v. J.R. Mktg., L.L.C*. (2015) 61 Cal.4th 988, 997-98.) In that circumstance, the insured's

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independent counsel "then controls the litigation." (*Assurance Co. of Am. v. Haven* (1995) 32 Cal.App.4th 78, 84 [38 Cal.Rptr.2d 25]; See *Intergulf Dev. LLC v. Superior Court* (2010) 183 Cal.App.4th 16, 20 ["Breach of duty to defend also results in the insurer's forfeiture of the right to control defense of the action or settlement . . . ."]; But see *Fuller-Austin Insulation Co. v. Highlands Ins. Co*. (2006) 135 Cal.App.4th 958, 984 & 987 ["An insurer does not breach any duty to the insured merely by reserving its rights under the policy"; however, "[i]t would impose an unnecessary burden on primary insurer and parties to an underlying action to hold that an excess insurer has an absolute right to withhold its consent to a settlement, while at the same time decline to participate in the action."].)

While an insured sometimes can settle over its insurer's objection, the better approach is to seek consent. If consent cannot be obtained, an insured should ask its insurer to agree not to assert the consent condition as a coverage defense, while agreeing that the insurer can reserve its other rights to deny coverage (including as to the reasonableness of the settlement). This may enable both the insured and the insurer to minimize their risks, while advancing settlement.

An insurer's right to settle when its insured objects

While an insured may be able to settle over its insurer's objection, the converse also is true – an insurer can settle over its insured's objections in an appropriate situation. And, when it does so, it may be able to sue its insured for reimbursement based on its coverage defenses, even if the insurer disputes coverage and the insured objects to the settlement. (See *Blue Ridge*, *supra,* 25 Cal.4th at 502-03.) This is so because of the strong public policy favoring settlements. (*Id.* at p. 503.)

However, an insurer does not have an unfettered right to settle. Generally, an insurer cannot, "without the knowledge or consent of the client, . . . compromise with impugnity [a lawsuit] for reasons foreign to the client's substantial rights or best interests." (*Rothtrock v. Ohio Farmers Ins. Co*. (1965) 233 Cal.App.2d 616, 623.) Nor can it compromise or give up its insureds' rights, claims, or remedies. In fact, an insurer has a duty "to do nothing to interfere with [an insured's] rights" against a party who has sued the insured. (*Barney v. Aetna Cas. & Sur. Co*. (1986) 185 Cal.App.3d 966, 981.) "An insured reasonably expects that the insurer, in using authority granted under the policy, will not knowingly effect a settlement which works to the detriment of the insured." (*Id.* at p. 977.) An insurer also cannot commit or spend any of its insureds' money in a settlement without their insureds' prior approval. (See, e.g., *Ivy v. Pacific Auto. Ins. Co*. (1958) 156 Cal.App.2d 652, 660-63 [insurer violated duty of good faith by stipulating without insured's consent to a judgment that exceeded the policy limits and left its insured exposed to other claims].) And, an insurer also cannot settle simply because it will save defense costs – even if those costs may substantially outweigh its potential indemnity duty. (See *Johnson v. Cont'l Ins. Cos*. (1988) 202 Cal.App.3d 477, 484-85 [insurer may not artificially exhaust its policy limits to walk away from its defense duty].)

Finally, an insurer must negotiate the most favorable settlement possible. The implied covenant of good faith and fair dealing carries "an obligation to conduct good faith settlement negotiations sufficient to ascertain the most favorable terms available and make an informed evaluation of any settlement demand." (*Diamond Heights Homeowners Ass'n v. Nat'l Am. Ins. Co*. (1991) 227 Cal.App.3d 563, 578.)

California's mediation confidentiality

Many litigants overlook the potential impact that California's mediation provisions may have on settlements. California Evidence Code section 1119(a) states:

> • No evidence of anything said or any admission made for the purpose of, in the course of, or pursuant to, a mediation or a mediation consultation is admissible or subject to discovery, and disclosure of the evidence shall not be compelled, in any arbitration, administrative adjudication, civil action, or other noncriminal proceeding in which, pursuant to law, testimony can compelled to be given.

(Evid. Code, § 1119(a).)

A similar prohibition extends to writings:

> • No writing . . . that is prepared for the purpose of, in the course of, or pursuant to, a mediation or a mediation consultation, is admissible or subject to discovery, and disclosure of the writing shall not be compelled, in any arbitration, administrative adjudication, civil action, or other noncriminal proceeding in which, pursuant to law, testimony can be compelled to be given.

(Evid. Code, § 1119(b).)

However, a communication or writing "is not made inadmissible, or protected from disclosure" if (i) "[a]ll persons who conduct or otherwise participate in the mediation expressly agree in writing, or orally," or (ii) the communication, document, or writing was prepared by or on behalf of fewer than all of the mediation participants, and those participants expressly agree to the disclosure." (Evid. Code, § 1122.)

California courts have enforced the rules barring discovery and admissibility of mediation communications, even in extreme circumstances. For example, in *Foxgate Homeowners' Ass'n v. Bramalea California, Inc.* (2001) 26 Cal.4th 1, the California Supreme Court considered the appropriateness of a sanctions order based on allegedly dilatory and obstructive conduct during a mediation. The trial court had granted sanctions against a party and its counsel, based in part upon a mediator's declaration that counsel had aborted the mediation session by refusing to participate in good faith. The Supreme Court ruled that the order for sanctions was inappropriate and constituted an irregularity in the proceedings. (*Id.* at p. 18.) It held that if a sanctions motion were pursued on remand, "No evidence of communications made during the mediation may be admitted or considered." (*Ibid.*) It reasoned that

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because mediation confidentiality is designed to promote "a candid and informal exchange regarding events in the past," that exchange "is achieved only if the participants know that what is said in the mediation will not be used to their detriment through later court proceedings and other adjudicatory processes." (*Id*. at p. 14.) The court expressly stated:

> [W]e do not agree . . . that the court may fashion an exception for bad faith in mediation because failure to authorize reporting of such conduct during mediation may lead to "an absurd result" or fail to carry out the legislative policy of encouraging mediation.

(*Id.* at p. 17.)

In fact, the confidentiality requirements sweep quite broadly:

> [T]he confidentiality rule in section 1119 sweeps broadly: it bars discovery and evidence of "anything said" not merely "in the course of" mediation, but "for the purpose of. . . , or pursuant to" mediation. Only certain communications made after the end of the mediation, or falling under other enumerated exceptions, escape its reach. Thus, the confidentiality rule in section 1119 encompasses communications by participants before the end of mediation that are materially related to the purpose of the mediation, regardless of whether these communications are made in the mediator's presence.

(*Eisendrath v. Superior Court* (2003) 109 Cal.App.4th 351, 363.)

For example, in *Cassel v. Superior Court* (2011) 51 Cal.4th 113, the California Supreme Court held that mediation confidentiality applied to "all discussions conducted in preparation for a mediation, as well as all mediation-related communications that take place during the mediation itself. . . ." (*Id*. at p. 128.) The court noted, "Plainly, such communications include those between a mediation disputant and his or her own counsel, even if these do not occur in the presence of the mediator or other disputants." (*Ibid.*) The court emphasized that the confidentiality extends to communications that "occur away from other mediation participants and reveal nothing about the mediation proceedings themselves." (*Id*. at p. 129.)

It further explained:

> The California Law Revision Commission comment … states, in its analysis . . . , that "mediation documents and communications may be admitted or disclosed only upon agreement of *all participants, including not only parties* but also the mediator and *other nonparties attending the mediation* (e.g., a disputant not involved in litigation, a spouse, an accountant, *an insurance representative*, or an employee of a corporate affiliate)."

(*Id.* at p. 131 (final emphasis added).)

Mediation confidentiality provisions have practical implications for parties in several contexts, particularly when an insured is seeking coverage from an insurer. For example, an insurer that refused to attend or participate in a mediation might not be able to force the insured to tell it what happened in the mediation, what positions were taken, or the bases for any settlement achieved at the mediation. (See *American Int'l Specialty Lines Ins. Co. v. Coca-Cola Enters. Inc.* (Cal. San Francisco Super. Ct. Oct. 14, 2003) Case No. 320748, Slip op. at 14 ["The Referee recognizes that access to settlement information is crucial for [the carrier], and one might conclude that it appears inherently unfair that [the insured] can request reimbursement, yet not provide the details by shielding them within the mediation privilege. But the California Supreme Court has made it clear that this is the way the statutory scheme operates, and with very limited statutory exceptions, all communications, negotiations, discussions or findings resulting from a mediation are confidential."].)

Another problem is presented for insureds and insurers if they would like to use communications or materials from a mediation to establish that there was an opportunity to settle a claim, or that an insurer did or did not consent to a settlement. In that situation, the materials arguably would not be discoverable or admissible in evidence in a subsequent legal proceeding without the consent of all involved in the mediation, or at least without the insured and insurer's agreement if they were the only ones involved in the communication. Thus, if the underlying plaintiff objected to the disclosure of information, then the insured or the insurer – or both – could find themselves handicapped in terms of the evidence available in a coverage action – for example, to show the course of offers and counter-offers or what was said by the mediator (including any assessments of the insured's potential liability, a mediator's recommendation to settle, or a "mediator's proposal").

Therefore, it is important for the parties engaging in mediation to consider when and how to communicate outside of a mediation. One way is for plaintiffs' counsel to send a settlement demand outside of the mediation (even if protected by Evidence Code section 1152) that makes no mention of the mediation. Another is for mediation participants to obtain, as part of a mediation agreement or a settlement, authorization to use relevant mediation communications in coverage disputes. Yet another is for the parties to agree to the use of communications showing an insurer's consent or refusal to consent to a settlement, and the insured's response thereto. And, if the insurer will consent, but wants to reserve its right to dispute the reasonableness of a settlement of certain coverage defenses, then the parties may wish to waive the protections afforded by the mediation confidentiality at least as to those communications.

There is one other point that should be kept in mind: Many mediation providers require mediation participants to sign confidentiality agreements. Those agreements typically have provisions barring discovery or use of mediation communications. They, too, may serve to limit the ability to disclose or use mediation communications. Therefore, exceptions should be included in such agreements or via separate writings that ensure the ability to use mediation communications in a coverage dispute.

Kirk Pasich has more than 35 years of experience handling complex insurance coverage matters. He is a mediator with Signature Resolution.