No. S211645

IN THE SUPREME COURT OF THE STATE OF CALIFORNIA

HARTFORD CASUALTY INSURANCE COMPANY,

Defendant, Cross-Complainant, and Appellant

v.

J.R. MARKETING, LLC, JANE A. RATTO, ROBERT E. RATTO, PENELOPE A. KANE, LENORE DEMARTINIS, GERMAIN DEMARTINIS, SCOTT HARRINGTON, SQUIRE SANDERS (US) LLP,

Plaintiffs, Cross-Defendants, and Respondents.

After A Decision By The Court Of Appeal, First Appellate District, Division Three, No. A133750
San Francisco County Superior Court, No. CGC-06449220, The Honorable Ronald E. Quidachay; The Honorable Loretta Giorgi; The Honorable Lynn O'Malley-Taylor

ANSWERING BRIEF ON THE MERITS

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I. ISSUE PRESENTED FOR REVIEW

When an insurer has breached its duty to defend its insureds in a lawsuit, and has been ordered to pay the insureds' defense costs, may the insurer directly sue the insureds' independent *Cumis*[1] counsel for quasi-contractual reimbursement, based on counsel's fees allegedly being unreasonable or excessive?

II. INTRODUCTION

Appellant Hartford Casualty Insurance Company ("Hartford") asks this Court to recognize a new cause of action that not only threatens the independence of *Cumis* counsel, but also rewards insurers that have breached their duty to defend their insureds. This proposed claim, which is unsupported by and contradicts California law and policy, is part of Hartford's ongoing efforts to avoid its duty to defend its Insureds[2] and undermine their choice of independent counsel.

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[1] *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.* (1984) 162 Cal.App.3d 358, 375.

[2] The "Insureds" are Respondents J.R. Marketing, LLC, Noble Locks Enterprises, Inc., Jane A. Ratto, Robert E. Ratto, Penelope A. Kane, and Lenore DeMartinis.

When the Insureds were sued in the underlying litigation, they asked Hartford to provide them with a defense. Hartford refused, and so the Insureds retained Respondent Squire Sanders (US) LLP ("Squire Sanders") as independent *Cumis* counsel. In the Insureds' coverage action, Hartford continued to deny its duty to defend and fought the Insureds' choice of *Cumis* counsel, but was ultimately ordered to pay the Insureds' defense costs in the underlying litigation. Hartford proceeded to violate that order by refusing to pay defense costs and refusing to acknowledge the Insureds' choice of *Cumis* counsel. Then, after the underlying litigation concluded, Hartford asserted "reimbursement" claims against its Insureds and their independent counsel, contending that the defense costs were allegedly excessive and unreasonable. The courts below roundly rejected Hartford's attempt to directly sue independent counsel, based on arguments substantially similar to those Hartford now raises once again.

Hartford contends that this Court should recognize a quasi-contractual right of breaching insurers to seek reimbursement directly from their insureds' independent *Cumis* counsel, in addition to seeking reimbursement from their insureds. This Court should reject

Hartford's invitation, as did the courts below, for at least two fundamental reasons. First, Hartford's novel right of action would critically (and needlessly) undermine the essential independence of counsel and the other core purposes that lie at the heart of Section 2860 of the Civil Code and the *Cumis* doctrine; it would, for example, fundamentally impair the attorney-client relationship between *Cumis* counsel and insureds when that relationship is most in need of protection from breaching insurers. Second, existing law already affords such insurers all the relief to which they are entitled, pursuant to the express contract of insurance they have with their insureds, and under "[l]ong-standing common law principles" of "restitution." (AOB at p. 4.)

Allowing breaching insurers such as Hartford to proceed directly against the insured-client's *Cumis* counsel would frustrate the basic goals of Section 2860, foremost of which is ensuring insureds' access to independent, non-conflicted counsel. Exposing *Cumis* counsel to after-the-fact challenges undermines this fundamental goal by casting a long shadow of doubt upon counsel, especially in circumstances such as these, where the insurer has abandoned its insureds and breached its obligation to defend them—circumstances

in which the insureds are in greatest need of truly independent, qualified counsel to protect their interests. Insureds will suffer, contrary to the basic goals and purpose of Section 2860, if whatever lawyers they are able to retain under Hartford's regime are forced to defend their clients with one eye over their shoulder, unduly influenced by the threat of being sued by insurers challenging counsel's every judgment call, litigation strategy, decision, or work product as "unreasonable" or "excessive," potentially years after the fact, even if they prevail in the underlying litigation.

Hartford's novel proposed right of direct reimbursement from *Cumis* counsel would also upend the carefully crafted set of incentives, benefits, and protections embodied in Section 2860. It would conflict with the Legislature's evident intent in Section 2860 to encourage insurers *not* to breach their duty to defend. It would also severely compromise the ability of insureds to find qualified, non-conflicted counsel willing and able to defend their interests in the face of insurers who have abandoned them and laid them bare, not only by threatening such counsel with insurer-initiated litigation challenging (with the benefit of hindsight) counsel's every judgment call and work product in the underlying litigation, but also by jeopardizing the

due process and other rights of independent counsel to defend themselves against charges of overbilling, if the requisite evidence is subject to an unwaived privilege. That is clearly not what the Legislature intended in enacting Section 2860. And there is no need to incur these highly troubling and problematic effects that would flow from adopting Hartford's novel cause of action, as more-than-sufficient safeguards already exist to guard against and remedy overbilling by *Cumis* counsel, including the Rules of Professional Conduct, as well as traditional remedies that clients have—and that clients alone may decide to seek—against their lawyers.

Not only does Hartford have no answer to these fundamental problems plaguing its proposed direct right of action against *Cumis* counsel, but it also offers no authority therefor, beyond inapt cases generally discussing the law of restitution. Contrary to Hartford's suggestion, this Court's decision in *Buss v. Superior Court* (1997) 16 Cal.4th 35 (*Buss*), lends no support to Hartford's position. Indeed, in *Buss*, this Court addressed and contemplated a far more limited right to restitution from the *insured*, and one closely tethered to the terms of the express contract of insurance between the insurer and insured.

More fundamentally, Hartford's proposed rule actually *conflicts* with well-established law limiting the reach of quasi-contract when express contracts are on point, as here. Under "traditional principles of restitution" and "long-standing common law principles" (AOB at pp. 4, 32), a party may not recover for "unjust enrichment" where the alleged benefit conferred on a third party (Squire Sanders) is simply *incidental* to the party's (Hartford's) performance of its contractual obligations under an express contract (the contract of insurance) between that party and another party with which it has contracted (the Insureds). Rather, to the extent Hartford believes it overpaid for the Insureds' defense costs, it already has contractual remedies against the party with which it bargained, and is in fact pursuing them.

Allowing breaching insurers to sue *Cumis* counsel directly for reimbursement would also run counter to well-established principles designed to safeguard the inviolability of the attorney-client relationship, particularly against third parties who lack standing to interfere with that vital relationship of trust, confidence, and undivided loyalty.

In sum, Hartford's proposed right of action has no support in law or policy and undermines the ability of insureds to retain truly

independent counsel to protect their interests after they have been abandoned by their insurers. This Court should therefore reject Hartford's arguments, affirm the judgment of the Court of Appeal, and hold that a breaching insurer may not seek restitution for allegedly unreasonable or excessive fees directly from *Cumis* counsel.

III. FACTUAL AND PROCEDURAL BACKGROUND

A. Hartford Enters Into A Bargained-For Contract With The Insureds But Breaches Its Duty To Defend.

In the summer of 2005, Hartford issued business insurance policies to J.R. Marketing, LLC and Noble Locks Enterprises, Inc. (1 Appellant's Appendix ("AA") 8-9.) In September 2005, a group of individuals led by Meir Avganim sued the Insureds for a variety of business torts in Marin County Superior Court (the "Avganim action"). (1 AA 9.)

In January 2006, Hartford disclaimed coverage of the Avganim action and refused to pay for the Insureds' defense costs, despite its self-described "duty to defend its insureds and to provide them with *Cumis* counsel." (AOB at p. 18; 1 AA 9.) The Insureds accordingly retained Squire Sanders as their independent *Cumis* counsel. Shortly thereafter, Squire Sanders filed a coverage suit (the "Coverage action") on the Insureds' behalf against Hartford, claiming breach of

contract and breach of the covenant of good faith and fair dealing, due to Hartford's refusal to defend the Insureds in the Avganim action. (2 AA 271-278.)

B. The Trial Court Orders Hartford To Pay The Insureds' Defense Costs.

After briefing on summary adjudication, the trial court found in July 2006 that Hartford had a duty to defend the Insureds in the Avganim action, and ordered Hartford to honor its obligation to pay for the Insureds' *Cumis* counsel. (1 AA 10.) Hartford nonetheless continued to flout its duty to timely pay the Insureds' defense costs, either paying invoices several months after they were received, or paying significantly less than what Hartford owed. (1 AA 4.) Indeed, rather than complying with this order, in August 2006 Hartford moved to disqualify Squire Sanders as counsel for the Insureds in this action. (1 AA 148-166.) That late scorched-earth tactic by Hartford was roundly rejected, however, by both the trial court and the Court of Appeal, which specifically noted that Hartford waited to seek disqualification "for tactical reasons" until after the trial court found that it had a duty to defend the Insureds. (1 AA 168-183.)

Hartford's intransigence forced the Insureds to seek further relief from the trial court. They moved to enforce the trial court's

summary adjudication order, and asked the court to compel Hartford to pay past invoices within fifteen days of the court's order, and to pay future fees and costs within thirty days of receipt of future invoices. (1 AA 4, 60.)

In response, the trial court granted the Insureds' motion, and ordered Hartford to pay past and future fees and costs (the "Enforcement Order"). (1 AA 10-11.) The court found that Hartford "has breached and continues to breach its defense obligations by (1) failing to pay all reasonable and necessary defense costs incurred by the insured and by (2) failing to provide *Cumis* counsel." (1 AA 3.) As a result of Hartford's breach, the court concluded that Hartford could not:

> unilaterally take advantage of the rate limitation provision of Section 2860. Indeed, such an outcome would encourage insurers to reject their *Cumis* obligations for as long as they chose, safe in the notion that they could, at any point, invoke the protection of the statute, effectively forcing the policyholder to transfer the file to yet another law firm whose rates are lower. The Court finds that, particularly in this case, such a result would work an injustice, since Hartford has already forced its policyholders to transfer the defense of the *Avganim* matter from Squire Sanders to Hartford's panel counsel, only to have it come back again.

(1 AA 4.)

Hartford appealed from the Enforcement Order, as well as the trial court's summary adjudication order finding that Hartford had a duty to defend the Insureds in the Avganim action. (1 AA 61.) In November 2007, the Court of Appeal affirmed both orders, agreeing that Hartford had a duty to defend the Insureds, and holding that the Enforcement Order was fully justified; it also held that "Hartford was not entitled to the protections of section 2860 . . . [g]iven th[e] evidence of Hartford's ongoing failure to meet its duty to defend . . . ." (1 AA 76-77.) Further, the Court of Appeal concluded that Hartford was "at odds with [the Insureds] in developing defenses in the *Avganim* matter, triggering the right to *Cumis* counsel under section 2860." (1 AA 72.)

C. After The Underlying Litigation Concludes, Hartford Sues The Insureds *And* Squire Sanders In Quasi-Contract For Reimbursement.

Despite Hartford's efforts to undermine the Insureds' defense, the Insureds ultimately prevailed in the underlying litigation and in October 2009, the Avganim action and other related cases were resolved. (1 AA 11; 2 AA 308-309.) After again unsuccessfully challenging the Enforcement Order (1 AA 228-249), in July 2011, Hartford filed its First Amended Cross-Complaint, raising claims

against both the Insureds *and* Squire Sanders. (1 AA 6-17.) Hartford asserted four claims against these parties: (1) "reimbursement of all or part" of the funds paid to cover the Insureds' defense costs; (2) unjust enrichment; (3) accounting/money had and received; and (4) rescission. (1 AA 6.)

Squire Sanders and the Insureds (together, the "Cross-Defendants") collectively demurred to Hartford's cross-complaint, and the trial court sustained the demurrer. (1 AA 21-47; 2 AA 430.) The court reasoned that "legal analysis and policy considerations, [including] protecting the integrity of the attorney-client relationship between the insured and their counsel," counseled against permitting an insurer to seek reimbursement directly from *Cumis* counsel. (*Ibid.*) The trial court permitted Hartford to proceed with its reimbursement claim against the Insureds. (*Ibid.*)

D. The Court Of Appeal Affirms And Holds That Hartford May Not Seek Quasi-Contractual Reimbursement Directly From Squire Sanders.

Hartford appealed from the trial court's demurrer ruling, and the Court of Appeal unanimously affirmed. (*J.R. Marketing, LLC v. Hartford Casualty Insurance Co.* (2013) 158 Cal.Rptr.3d 41, 44 (*Hartford*).) The Court of Appeal agreed with the trial court that

"important policies—to wit, those underlying the enactment of section 2860—would indeed be frustrated by allowing Hartford to directly sue Squire [Sanders] for reimbursement." (*Id.* at p. 51.) The Court of Appeal noted that "[t]o hold otherwise would effectively afford the insurer that has waived the protections of section 2860 through its own wrongdoing more rights in a fee dispute with independent counsel than the insurer that has not waived such protections," and rejected Hartford's proposed direct right of restitution from *Cumis* counsel to avoid "this inequitable result." (*Id.* at p. 52.)

The Court of Appeal also rejected Hartford's argument that a direct right of restitution derived from this Court's decision in *Buss*. (*Id.* at p. 51.) Finally, the Court of Appeal criticized Hartford for breaching its duty to defend, noting that "had Hartford met its duty to defend . . . the issue of its right to directly sue Squire for reimbursement would not have arisen." (*Id.* at p. 52, fn. 11.)

E. A Jury Finds Hartford Breached Its Contract With The Insureds, And The Trial Court Permits Hartford To Seek Reimbursement From The Insureds.

In the meantime, the Insureds' remaining claims proceeded to a jury trial. In December 2012, a jury found that Hartford had breached

its contract with the Insureds, though it declined to find that Hartford's breach was in bad faith. (Appellant's Supp. MJN, ex. A, p. 3.)

Afterwards, the court held a bench trial on Hartford's claim for reimbursement from the Insureds. (*Ibid.*) The latest judge to preside over this case in the trial court (there have been at least three to date) issued two tentative statements of decision, at first granting Hartford reimbursement of $5,206,730 from the Insureds, and then decreasing that award to $4,997,395. (*Id.* at p. 2; Appellant's MJN, ex. A, p. 2.) The Insureds filed objections challenging the trial court's tentative decision, and the trial court issued a final statement of decision, which remains deeply flawed, further decreasing its reimbursement award to $4,857,832. (Appellant's Further Supp. MJN, ex. A, p. 2.) That decision, of course, does not impact the appeal before this Court, and will likely be subject to its own appeal in due course.[3]

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[3] Squire Sanders will not attempt to prematurely litigate in this Court the various tentative and final reimbursement decisions from the trial court of which Hartford has requested judicial notice. Squire Sanders respectfully submits that this Court should not be distracted by these unreviewed findings and conclusions in resolving the issues of law presented here.

IV. ARGUMENT

A. Hartford's Proposed Right of Action Would Needlessly And Seriously Impair Section 2860, The *Cumis* Doctrine, And The Attorney-Client Relationship Between *Cumis* Counsel And The Insured.

Hartford's proposed quasi-contractual claim for reimbursement from *Cumis* counsel would undermine the vital policies animating the entire *Cumis* doctrine codified in Section 2860.[4] And, as Hartford recognizes, a party cannot recover in quasi-contract where such a recovery would undermine established public policy. (E.g., *California Emergency Physicians Medical Group v. Pacificare of California* (2003) 111 Cal.App.4th 1127, 1136; see also AOB at p. 26.)

Cumis and Section 2860 are designed to safeguard insureds' right to independent counsel free of conflicts of interest and uncompromised by the possibility of divided loyalties, and to incentivize insurers to honor their duty to defend their insureds, rather than laying them bare to fend for themselves, as Hartford did here.

Adopting Hartford's proposed rule would defeat these vital policy goals. It would subject independent counsel to an intractable

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[4] All statutory references, unless otherwise stated, are to the Civil Code.

conflict between their duty to defend insureds and their own interest in avoiding personal liability in insurer-initiated, after-the-fact litigation second-guessing that defense. In at least one important respect, it would also put breaching insurers in a potentially *better* position than their competitors who complied with Section 2860's requirements, by permitting them to challenge (with the benefit of hindsight) defense costs and fees as "excessive" or "unreasonable," potentially years after the underlying litigation has concluded. Independent counsel facing a restitution action may also find themselves unable to defend themselves by relying on evidence subject to the attorney-client privilege. And there is no need for the rule Hartford proposes: the ethics rules already prohibit any lawyer from charging unconscionable fees, and insureds can choose to sue or seek appropriate relief from their counsel if an insurer seeks to recover legal fees from the insured.

Hartford's proposed rule would therefore seriously compromise and undermine the basic purpose of Section 2860—to protect the interests of insureds by making sure they have access to qualified, conflict-free counsel—and should be rejected by this Court.

1. Section 2860 Guarantees Insureds Access To Qualified And Truly Independent Counsel And Disincentivizes Insurers From Breaching Their Duty To Defend.

Section 2860 of the Civil Code was enacted in 1987 to codify the core holding in *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.* (1984) 162 Cal.App.3d 358, 375 (*Cumis*): that "where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based upon possible noncoverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured." Section 2860 was thus enacted to protect insureds by ensuring access to qualified and entirely independent counsel that would vigorously represent the insureds' interests.

In *Cumis*, the Court of Appeal explained the nature of the predicament facing an insured where "the insurer promises to defend but states it may not indemnify the insured if liability is found." (*Id.* at p. 364.) Under those circumstances, the interests of the insured and the insurer no longer align: the insurer has an interest in avoiding coverage through a liability finding in the underlying litigation based on a ground *not* covered by its policy, while the insured has the

conflicting interest in obtaining coverage through a liability finding that *would* trigger the insurer's duty to indemnify. (*Ibid.*)

When such an "actual, ethical conflict of interest" arises, a lawyer may not represent both the insurer and the insured. (*Id.* at p. 375.) Were a lawyer to attempt to do so, he or she would be "forced to walk an ethical tightrope, and not communicate relevant information which is beneficial to one or the other of his clients"; "[n]o matter how honest the intentions, counsel [could not] discharge [these] inconsistent duties." (*Id.* at p. 366.)

The *Cumis* doctrine therefore came into existence in order "to protect an *insured's* interest." (*J.C. Penney Casualty Insurance Co. v. M. K.* (1991) 52 Cal.3d 1009, 1018.) *Cumis* "intended to eliminate the ethical dilemmas and temptations that arise along with conflict in joint representations" by "mandating the insured's right to *Cumis* counsel that represent *only* the insured." (*Employers Insurance of Wausau v. Albert D. Seeno Construction Co.* (N.D.Cal. 1988) 692 F.Supp. 1150, 1157-1158, italics added.) Section 2860 realizes this goal by codifying insureds' right to qualified and truly independent counsel. (See *Musser v. Provencher* (2002) 28 Cal.4th 274, 282-283

(*Musser*), quoting *Kroll & Tract v. Paris & Paris* (1999) 72 Cal.App.4th 1537, 1542.)[5]

Courts applying Section 2860 have recognized this fundamental purpose underlying the statute, and have consistently interpreted the statute to protect the independence of the insureds' counsel. For example, in *Dynamic Concepts, Inc. v. Truck Insurance Exchange* (1998) 61 Cal.App.4th 999 (*Dynamic Concepts*), the court questioned the "wisdom and propriety of so-called 'outside counsel guidelines'" that might "violate the insurer's duty to defend *as well as* the attorneys' ethical responsibilities to exercise their independent professional judgment." (61 Cal.App.4th at p. 1009 & fn. 9, italics added.) Such guidelines must not "be permitted to impede the

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[5] Specifically, Subdivision (a) requires an insurer to provide "independent counsel" where a conflict of interest arises between the insurer and the insured. (Civ. Code, § 2860, subd. (a).) Subdivision (c) establishes minimum qualifications for independent counsel selected by the insured, limits the insurer's obligation to pay fees to those "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," and provides for mandatory arbitration of "[a]ny dispute concerning attorney's fees" not resolved by contractual dispute-resolution mechanisms. (*Id.*, subd. (c).) And Subdivision (d) requires independent counsel and the insured to disclose "all information concerning the action" to the insurer, *except* for "privileged materials relevant to coverage disputes." (*Id.*, subd. (d).)

attorney's own professional judgment about how best to competently represent the insureds." (*Ibid.*) Instead, "[i]f the attorney's representation is to be limited in any way that unreasonably interferes with the defense, it is the *insured*, not the insurer, who should make that decision." (*Ibid.*, italics added.)

Similarly, in *Assurance Co. of America v. Haven* (1995) 32 Cal.App.4th 78, 81 (*Assurance Co.*), the court concluded that "*Cumis* counsel cannot be held negligently or statutorily liable *to the insurer*" for failing to develop a complete defense to liability.[6] Recognizing a general duty of care owed by independent counsel to an insurer where there is a conflict of interest between the insurer and insured would subject independent counsel to "the oftentimes subtle ethical dilemmas and temptations that arise along with conflict in joint representations." (*Id.* at p. 87.) Permitting an insurer to sue independent counsel would thus jeopardize the essential and "*complete independence of counsel*" that lies at the heart of the *Cumis* doctrine. (*Ibid.*)

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[6] The court held, however, that the non-breaching insurer could sue for a breach of specific duties owed by independent counsel to the insurer under Section 2860. (*Id.* at p. 87.)