

By David Ezra

How *Presley Homes* Has Changed the Duty to Defend

The appellate court's impact on construction defect litigation may turn out to be limited

Any attorney who participates in construction defect litigation quickly becomes familiar with the difficulties that can arise when 20 or 30 different insurance policies provide potential coverage, and a duty to defend, for a single developer that has been sued by a group of homeowners or a homeowners' association. Disputes about access to information, who controls the defense, and how defense costs should be divided among defending insurers seem to be all too common.

Some attorneys believe that a recent decision by the Fourth District Court of Appeal—namely, *Presley Homes, Inc. v. American States Insurance Company*¹—promises to radically change the nature and resolution of disputes regarding the duty to defend in construction defect cases. And while *Presley* can be important in a few situations, for run-of-the-mill construction defect litigation, *Presley* did not really change anything. The same debate that existed before *Presley* continues to exist in most construction defect lawsuits.

The crux of this debate can be traced back to 1997, when the California Supreme Court announced a “prophylactic” duty to defend uncovered claims in so-called mixed actions.² In these suits, some causes of action are covered and some are not. Before the 1997 decision—*Buss v. Superior Court*—policyholders and insurers had different ideas about mixed actions. Policyholders argued that the insurance company had to pay for the defense of all causes of action if any one cause of action was potentially covered under the liability insurance policy. The only way the insurer could avoid paying for the defense of particular causes of action was to produce “undeniable evidence” showing that specific fees and expenses were allocable only to uncovered causes of action.³ On the other hand, liability insurers argued that the standard of undeniable evidence of allocability applied only in situations in which the insurer had wrongfully denied its duty to defend. If an insurer

defended or innocently (but mistakenly) denied a request for defense, then a fair allocation of the fees and expenses between the covered and the uncovered causes of action was to be considered appropriate.⁴

In resolving this debate, the *Buss* decision introduced a new concept to California law: the liability insurer's prophylactic duty to defend. The *Buss* court concluded that it could not justify

imposing an obligation to defend uncovered causes of action in mixed lawsuits that was based on policy language alone.⁵ The policy merely obligates the insurer to defend those causes of action that are potentially covered and nothing more. But the *Buss* court also held that the law imposes on insurers a prophylactic duty to defend the entire lawsuit, including causes of action that are not even potentially covered, if the lawsuit includes some covered and some uncovered causes of action.⁶ According to *Buss*, the law imposes this prophylactic duty to protect policyholders from the hardship that would result if certain causes of action were not defended at all.⁷

Buss emphasized that the prophylactic duty to defend uncovered claims differs substantially from a true contractual duty to defend claims that are in fact potentially covered. The contractual duty to defend is a true duty that exists for all purposes. When a cause of action is potentially covered under a liability insurance policy, the insurer has to fund the insured's defense against the third party's claim. In this situation, the insurer is not entitled to reimbursement, even if it turns out that the third party is unable to prove the claim, and even if actual coverage never develops.

In sharp contrast, the prophylactic, or protective, duty to defend can be ephemeral. When necessary to protect against the hardships that would exist if defense attorneys refused to mount any defense to uncovered claims, the insurer with a prophylactic duty to defend must

front legal fees and expenses incurred to defend claims that are not potentially covered, as long as at least one cause of action is potentially covered. However, the insurer that provides a prophylactic defense of uncovered causes of action is entitled to seek reimbursement at the conclusion of the litigation.⁸ The insurer has to show that certain fees and expenses are solely allocable to uncovered causes of action. The burden of proof for the insurer is merely a preponderance of evidence.⁹

The Duty to Defend

Presley is important, but only because the decision applies the prophylactic duty to defend as established in *Buss* to additional insured carriers in the construction defect context.¹⁰ Developers who build residential housing typically require the subcontractors who do the construction work to have their own liability insurance policies. The developers and general contractors also usually require subcontractors to make sure that their insurance policies name the developers as additional insureds. Most commonly, developers are added by an endorsement that essentially says that they will be treated as insureds, but only with respect to liability arising from the work performed by the named insured subcontractor.

Since construction defect lawsuits often involve numerous alleged defects, large groups of damages that might be alleged against a developer can have nothing whatsoever to do with issues that have been alleged against a particular subcontractor.

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As a result, the additional insured coverage afforded under a particular subcontractor's policy might provide coverage for only a very small percentage of the overall construction defect lawsuit.

Presley apparently involved an ordinary construction project. American States insured two of the subcontractors that worked on the project. One subcontractor installed concrete foundations, driveways, walkways, and stoops. The other purchased lumber and did rough carpentry work. Both subcontractors had their policies endorsed to make *Presley Homes* an additional insured. Each policy limited *Presley Homes*'s coverage to certain liabilities arising out of the named insured subcontractor's work.¹¹

Presley Homes and American States could not agree on the defense obligation. *Presley Homes* said American States had an obligation to provide a full and complete defense, but American States argued that it only had a duty to defend claims relating to its named insured subcontractors' work. American States offered to retain a separate lawyer who would represent *Presley Homes* with respect to framing issues. American States also talked about the idea of contributing a certain percentage to the overall defense costs. Ultimately, however, *Presley Homes* and American States could not agree, and *Presley Homes* filed suit.

On cross motions for summary adjudication, *Presley Homes* asked the court to rule that American States owed a 100 percent defense obligation. American States asked the court to rule that it did not owe a 100 percent defense obligation. The trial court ruled in favor of American States, finding that its defense obligation was limited.¹² The appellate court reversed, holding that *Presley Homes* "did incur legal expenses in defending against the [construction defect] suit."¹³ This sentence shows that *Presley Homes* was not being fully defended by any other insurer (or group of insurers) when American States was trying to negotiate a partial defense. Since *Presley Homes* was not being fully defended by anyone else, all the court of appeal had to do was apply *Buss*—and that is exactly what it did.

Although *Presley* has generated quite a commotion in construction defect litigation circles, the appellate result represents no great departure from previously existing law. The appellate court in *Presley* said that it rejected American States' argument "because an insurer's duty to defend the entire action is based on public policy, not the terms of the party's contract."¹⁴ Then the court cited and quoted extensively from *Buss*, noting: "[T]he delay in providing a defense while the parties attempted to reach a mutually accept-

able percentage, highlights the very reason the Supreme Court requires an insurer to provide a complete defense even where the underlying lawsuit includes both covered and uncovered claims."¹⁵

Although American States could correctly point out that its named insured subcontractors' work represented a relatively small percentage of the defects that were at issue in the lawsuit against *Presley Homes*, this was not enough to distinguish *Buss*. After all, in *Buss*, the California Supreme Court ruled that Transamerica had a duty to defend the entire lawsuit even though only one of 27 separate causes of action was potentially covered under Transamerica's policy.¹⁶

One Full Defense

The prophylactic duty to defend is not implicated if some other insurer is already providing a full defense. To be sure, neither *Buss* nor *Presley* expressly says so; however, the rationale behind the imposition of a prophylactic duty to defend uncovered claims evaporates if some other insurance company is already funding a full defense. The law imposes a prophylactic duty to defend uncovered claims to prevent situations in which an attorney works vigorously to defend the covered causes of action and not at all to defend the remaining uncovered causes of action.

But policyholders are only entitled to one insurer-funded defense, not several. And this is particularly true in construction defect litigation, in which one developer may request a defense from 20 or more different insurance companies. Once a policyholder receives a full defense from a particular insurer, another insurer's failure to defend is not actionable and has no consequences for the policyholder. For example, in *Ceresino v. Fire Insurance Exchange*,¹⁷ the court drew a distinction between situations in which an insurer's failure to defend left the policyholder defenseless and situations in which the failure to defend was far less meaningful because some other insurer was already fully defending.

Explaining its reasoning, the court noted: But *Ceresino* did not face that danger—his representation was undertaken by his other insurance company. Farmers' failure to *defend* was of no consequence except to Commercial Union, which requested Farmers pay for half the defense.¹⁸

In *Ringler Associates, Inc. v. Maryland Casualty Company*,¹⁹ the court held that it would not have allowed a policyholder to collect damages from the insurer who failed to defend, even if the insurer had a duty to defend. After explaining that the basic measure of damages is the amount required to compensate the policyholder for harm caused

by the insurer's breach of the duty to defend, the court noted:

Ringler suffered no liability in excess of the Policy limits; nor was it compelled to or unable to defend itself. Instead, as Ringler implicitly acknowledges, it was fully protected from having to pay any costs of its own defense by other insurers who were on the risk when Ringler allegedly first slandered the plaintiffs....²⁰

Another case, *National Union Fire Insurance Company v. Nationwide Insurance Company*,²¹ involved a dispute between insurers. The appellate court criticized National Union for its "strident references to Nationwide's 'bad faith' failure to defend...."²² Citing *Ceresino*, the court went on to explain: "To the contrary, National Union stepped in and fulfilled the very roles for which it received policy premiums. This dispute between insurance carriers is little served by co-opting rhetoric which more aptly applies to insureds who are left without any insurer-provided defense."²³

A similar point was made more recently in *Barratt American, Inc. v. Transcontinental Insurance Company*.²⁴ Barratt argued that one of its additional insured carriers had the burden to prove that the costs that Barratt had incurred to repair and upgrade homes that were not involved in litigation were not reasonable and necessary "defense costs." Barratt argued that traditional burden-of-proof rules were inapplicable because Transcontinental had "breached" its duty to defend. The court rejected Barratt's argument because Barratt had been defended by a different insurer.

As the court explained, "Transcontinental was never asked to provide additional legal counsel" and Barratt was not "left to mount its own defense."²⁵ Instead, "Barratt's direct insurer (Gerling) had accepted the duty to defend...and Barratt was fully represented by legal counsel paid by Gerling."²⁶ In a footnote the court explained that although there was some evidence that Gerling did not pay all the attorney's fees and expert bills that Barratt had incurred in a timely manner, there was no evidence showing that Barratt's "defense was impeded or that if those bills had been paid more promptly the defense would have been improved."²⁷

As these authorities show, from the standpoint of a developer that is already receiving a fully funded insurance defense, an additional insured carrier's obligation to defend is largely irrelevant. The developer is entitled to one insurer-funded defense, not several.²⁸ This is why the key fact in *Presley* was that *Presley Homes* was not receiving a full defense from any other insurer when

American States offered to provide a partial defense.

If Presley Homes had been receiving a full defense from its own direct insurer (or some other additional insured carrier, or some combination of insurers) when it asked American States to defend, Presley Homes would have held no rights against American States. Instead, those insurers that were funding the defense would have had the right to request equitable contribution from American States.

Allocation of Responsibility

When two or more insurers share an obligation to defend the same policyholder against the same lawsuit, courts allocate responsibility among those insurers based on equitable principles. The "purpose of this rule of equity is to accomplish substantial justice by equalizing a common burden shared by co-insurers, and to prevent one insurer from profiting at the expense of others."²⁹ There is no one fixed rule. Formulas that have been used to equitably allocate a shared defense obligation include comparison of policy limits, the amount of "time on the risk," the premiums paid, and the amounts contributed to a settlement.³⁰

Some attorneys have argued that the 100 percent prophylactic duty to defend outlined in *Presley* means that each insurer owes the same defense obligation. From there, they argue that equitable sharing between insurers must be based on equal shares, with each participating insurer contributing the same amount toward the defense regardless of whether or not other factors would make this approach inequitable.

There are certainly times when equitable allocation based on equal shares makes sense, but this approach is not required just because every insurer with an obligation to defend part of a lawsuit has a prophylactic obligation to defend the entire lawsuit. In fact, decisions after *Buss* and *Presley* have continued to endorse other methods of arriving at a fair contribution among insurers who share a common obligation to defend a policyholder. For example, *Fireman's Fund Insurance Company v. Maryland Casualty Company*³¹ noted that one valid equitable consideration would be whether a particular insurer stepped forward to acknowledge its defense obligation or, instead, refused to defend the policyholder. According to this logic, those carriers that are reluctant to acknowledge their defense obligation should pay a larger part of the common defense fees and expenses than those carriers that voluntarily step forward to defend.³²

In another decision after *Buss*, the court in *Maryland Casualty Company v. Nationwide*

*Mutual Insurance Company*³³ specifically rejected the notion that *Buss* and the prophylactic duty to defend uncovered claims has anything to do with division of responsibility among insurers who share a common defense obligation. As the court explained: "Unlike *Buss*, the issue here is not the scope of Nationwide's duty to defend. It is allocation of costs among several insurers *each of which had a duty to defend*."³⁴ And when it remanded the case for the trial court's consideration of the equitable contribution issue, the appellate court instructed the trial court to consider all relevant factors, including the scope of coverage afforded by the various policies.³⁵

In another post-*Buss* decision, *Centennial Insurance Company v. United States Fire Insurance Company*,³⁶ the court refused to equitably allocate defense fees and expenses among co-insurers based on an equal shares approach. In *Centennial*, the court concluded: "[T]he time on the risk method was much more equitable than the equal shares approach."³⁷

Even after *Presley*, California courts continue to hold that "[t]here is no single method of allocating defense or indemnity costs among co-insurers."³⁸ So the fact that each insurer with a duty to defend has a prophylactic duty to defend uncovered claims does not mean that every insurer will ultimately have the same defense obligation. The prophylactic duty to defend, after all, includes the right to seek reimbursement of fees that are allocable to uncovered claims.

Like *Buss*, *Presley* merely reiterates a rule that increases the likelihood that policyholders will be fully defended. If multiple insurers are obligated to defend, however, allocation of defense costs among those insurers will be based on equitable principles that can include an assessment of policy limits, premiums collected, time on the risk, the scope of coverage afforded under the policy, comparative contributions toward settlement, and each insurer's handling of the claim.

Presley is a helpful decision for additional insureds that are not receiving a full defense from an insurer or group of insurers. The case has nothing to say, however, about situations in which a policyholder is already receiving a full defense from one or more of its insurers. Similarly, *Presley* has little to say about equitable contribution among cocarriers. Although equal shares may be a fair and equitable approach to dividing fees and expenses in some situations, *Presley* does not mandate that approach.

Considering its modest holding, *Presley* has received too much attention, and it is probably cited too frequently. Attorneys who deal with construction-defect-related coverage issues might be able to better serve their

clients by identifying and citing cases that address the issues they are debating. *Presley* is not going to do much good if the insured is already receiving an insurer-funded defense or if equitable allocation among co-insurers is involved. ■

¹ *Presley Homes, Inc. v. American States Ins. Co.*, 190 Cal. App. 4th 571 (2001).

² *Buss v. Superior Court*, 16 Cal. 4th 35 (1997).

³ *Hogan v. Midland Nat'l Ins. Co.*, 3 Cal. 3d 553, 564 (1970).

⁴ *Scottsdale Ins. Co. v. Homestead Land Dev.*, 145 F.R.D. 523, 536 (N.D. Cal. 1992).

⁵ *Buss*, 16 Cal. 4th at 48.

⁶ *Id.* at 49.

⁷ *Buss* emphasizes a desire to protect insureds that will otherwise "be left defenseless." *Buss*, 16 Cal. 4th at 49 n.11 (citing *Scottsdale Ins.*, 145 F.R.D. 523).

⁸ *Buss*, 16 Cal. 4th at 50.

⁹ *Id.* at 54.

¹⁰ In *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 69 (1997), the supreme court extended the logic of *Buss*, allowing the prophylactic duty to defend and the right of reimbursement to attach "to a claim, or a part of a claim" that is not potentially covered.

¹¹ *Presley Homes, Inc.*, 90 Cal. App. 4th at 573-74.

¹² *Id.* at 573.

¹³ *Id.* at 574.

¹⁴ *Id.* at 576.

¹⁵ *Id.* at 576-77.

¹⁶ *Buss v. Superior Court*, 16 Cal. 4th 35, 42 (1997).

¹⁷ *Ceresino v. Fire Ins. Exch.*, 215 Cal. App. 3d 814 (1989).

¹⁸ *Id.* at 832 (emphasis in original).

¹⁹ *Ringler Assoc., Inc. v. Maryland Cas. Co.*, 80 Cal. App. 4th 1165 (2000).

²⁰ *Id.* at 1187. See also *Tradewinds Escrow, Inc. v. Truck Ins. Exch.*, 97 Cal. App. 4th 704, 712 (2002).

²¹ *National Union Fire Ins. v. Nationwide Ins. Co.*, 69 Cal. App. 4th 709 (1999).

²² *Id.* at 721 n.5.

²³ *Id.*

²⁴ *Barratt American, Inc. v. Transcontinental Ins. Co.*, 102 Cal. App. 4th 848 (2002).

²⁵ *Id.* at 864.

²⁶ *Id.*

²⁷ *Id.* at 864 & n.4.

²⁸ As one court put it when addressing an appropriate hourly rate for defense attorneys, under California Civil Code §2860, the policyholder's rights should not depend "fortuitously on the number of insurers that are called upon to defend." *San Gabriel Valley Water Co. v. Hartford Acc. & Ind. Co.*, 82 Cal. App. 4th 1230, 1242 (2000).

²⁹ *Golden Eagle Ins. Co. v. Insurance Co. of the West*, 99 Cal. App. 4th 837, 853 (2002).

³⁰ See, e.g., *Stonewall Ins. Co. v. City of Palos Verdes Estates*, 46 Cal. App. 4th 1810, 1861 (1996) and *Pacific Indem. Co. v. Fireman's Fund Ins. Co.*, 175 Cal. App. 3d 1191, 1201 (1985).

³¹ *Fireman's Fund Ins. Co. v. Maryland Cas. Co.*, 65 Cal. App. 4th 1279 (1998).

³² *Id.* at 1308.

³³ *Maryland Cas. Co. v. Nationwide Mut. Ins. Co.*, 81 Cal. App. 4th 1082 (2000).

³⁴ *Id.* at 1091 (emphasis in original).

³⁵ *Id.* at 1094.

³⁶ *Centennial Ins. Co. v. United States Fire Ins. Co.*, 88 Cal. App. 4th 105 (2001).

³⁷ *Id.* at 113.

³⁸ *Golden Eagle Ins. Co. v. Insurance Co. of the West*, 99 Cal. App. 4th 837, 854 (2002).