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NEWSLETTER

Insurer Can Challenge Reasonableness of Settlement Even if It Refuses to Defend or Indemnify

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In an unpublished decision, a California appellate court has held that an insurer is entitled to challenge the reasonableness of an underlying settlement by its insured even though the insurer had previously refused to defend or indemnify its insured. *Morris v. Employers Reinsurance Corp.*, 2004 WL 25243 (Cal. Ct. App. Jan. 5, 2004).

The insurer issued an E&O policy to a real estate broker. One of the broker's clients sued for breach of fiduciary duty and fraud in connection with the purchase of property. After the insurer refused to defend or indemnify the broker, the broker settled with the clients and assigned them rights under the insurance policy to the clients, who then sued the insurer.

The appellate court held that the insurer was entitled to present evidence that the settlement was unreasonable, notwithstanding its refusal to defend or indemnify. The court explained that, under California law, a policyholder seeking to collect on an insurance policy in these circumstances has the initial burden of proving that: (1) the insurer wrongfully denied coverage; (2) the policyholder settled without the insurer's consent and (3) the settlement was reasonable "in the sense that it reflected an informed and good faith effort by the insured to resolve the claim." The court explained that "[i]f the plaintiff insured (or its assignee) produces evidence of these foundational facts, then the burden of proof will shift to the defendant insurers to persuade the trier of fact, by a preponderance of the evidence, that [the underlying] settlement did not represent a reasonable resolution of plaintiff's claim or that the settlement was the product of fraud or collusion."

The appellate court also explained that, in evaluating reasonableness, the trial court must consider the reasonableness of the settlement at the time it was made, not retrospectively. The court explained that in this case the trial court should consider the facts known at the time of the settlement, the probability of success at trial, damages exposure, other potential causes of action and the valuation of the property. Finally, the court noted that while the existence of a good faith settlement was not binding on the insurer, that determination would have "some evidentiary value."

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