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New Federal Court Decision Protects Insurer's Decision Not To Continue Defending Policyholder During Appeal

By Samuel H. Ruby

What is an insurer to do when it obtains a declaratory judgment that it has no duty to defend, but the policyholder then appeals? Must the insurer continue to defend while the appeal is pending, or else risk a reversal that finds the insurer breached its duty to defend during the appeal period? In an issue of first impression in the Ninth Circuit, the federal district court in the Northern District of California held that an insurer did not violate its contract when it stopped defending a policyholder based on a trial court coverage victory that was later overturned.

In *National Union Fire Ins. Co. v. Seagate Technology*, No. 04-1593 (N.D. Cal. Jan. 25, 2013), the insurer obtained a declaratory judgment that its duty to defend the policyholder in underlying litigation terminated in 2007. As a result, the insurer ceased defending. Five years later, the Ninth Circuit Court of Appeals ruled that the trial court erred in concluding that the insurer's duty to defend had terminated in 2007. This decision obligated the insurer to pay defense costs from 2007 to 2012.

The insurer paid only part of the legal bills. The insurer based the reduced payment on a California statute, which limits the insurer's obligation to pay legal defense fees to rates the insurer pays to attorneys it retains "in the ordinary course of business . . . in similar actions." The policyholder argued that, based on the appellate court ruling, the insurer's decision to stop defending after the declaratory judgment in its favor was a breach of the duty to defend. According to the policyholder, because the insurer breached the duty to defend, it could not rely on the statutory rates, and instead must pay defense costs the policyholder actually incurred. This amounted to a difference of $20 million.

The court held that the insurer did not breach the duty to defend when it relied on the trial court's decision and ceased defending in 2007. The court stated that the insurer "was entitled to the benefit of the (erroneous) ruling that there was no longer a duty to defend. To hold that [the insurer] was committing a breach of contract all along would convert a final judgment under Rule 54(b) into a provisional one and directly conflict with the principle that absent a stay, a party must comply with a judgment pending appeal." "Reinstatement [of the duty to defend] does not require an additional finding of wrongful breach, however."

As noted, the *Seagate* case is a trial court opinion, and it may be subject to appeal. But unless it is reversed, the decision is instructive: An insurer can stop defending after a trial court decision that it has no duty to defend. If the decision is reversed on appeal, the insurer's obligation at that point should be payment of past defense costs, but without exposure for any consequences that may otherwise accompany a finding of a breach of the duty to defend.