*Nos. 07-15326, 07-15356, 07-15541*

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**IN THE**
**UNITED STATES COURT OF APPEALS**
**FOR THE NINTH CIRCUIT**

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AMERICAN COLOR GRAPHICS, INC.,

*Plaintiff-Appellee-Cross-Appellant,*

vs.

TRAVELERS PROPERTY CASUALTY INSURANCE COMPANY,

*Defendant-Appellant-Cross-Appellee.*

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On Appeal from the United States District Court
for the Northern District of California, Oakland Division
Case No. CV-04-03518-SBA
Hon. Saundra Brown Armstrong, Presiding

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# STATE COMPENSATION INSURANCE FUND'S AMICUS CURIAE BRIEF IN SUPPORT OF APPELLANT TRAVELERS PROPERTY CASUALTY COMPANY OF AMERICA (SEEKING REVERSAL)

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## CORPORATE DISCLOSURE STATEMENT
## (FED. R. APP. P. 26.1)

State Compensation Insurance Fund ("State Fund"), a Public Enterprise Fund of the State of California, was created pursuant to article XIV, section 4 of the California Constitution.

No individual or corporation owns 10% or more of the stock of State Compensation Insurance Fund.

## TABLE OF CONTENTS

Page

Table of Contents ........ i

Table of Authorities ........ ii

I. INTRODUCTION ........ 1

II. ARGUMENT ........ 6

A. THE UNDERLYING JUDGMENT IMPROPERLY EXTENDS THE APPLICATION OF THE "INSURANCE EXCEPTION" ........ 6

1. The Insurance Exception Exists to Protect the Insured in Times of Greatest Need ........ 6

2. The Insurance Exception is Inapplicable Where the Unique Interests it was Intended to Protect Are Not Implicated ........ 10

3. Tort Liability Cannot Be Imposed Based on the Exercise of Express Contractual Rights ........ 18

4. The *Security Officers* Line of Cases Are Inapplicable Here ........ 21

B. THE DISTRICT COURT'S DECISION NEGATIVELY IMPACTS THE ADMINISTRATION OF WORKERS' COMPENSATION CLAIMS AND FOSTERS UNNECESSARY CONFLICTS BETWEEN INSURERS, AND INJURED WORKERS AND EMPLOYEES ........ 27

III. CONCLUSION ........ 30

CERTIFICATE OF WORD COUNT ........ 31

## TABLE OF AUTHORITIES

## CASES

*Archdale v. American Internat. Specialty Lines Ins. Co.*,
154 Cal. App. 4th 449 (2007) ........ 2

*Camelot by the Bay Condominium Owners' Assn. v. Scottsdale Ins. Co.*,
27 Cal. App. 4th 33 (1994) ........ 15

*Carma Developers v. Marathon Development Cal.*,
2 Cal. 4th 342 (1992) ........ 19

*Cates Constr., Inc. v. Talbot Partners*,
21 Cal. 4th 28 (1999) ........ 3, 8, 9, 18

*Comunale v. Traders & General Ins. Co.*,
50 Cal. 2d 654 (1958) ........ 6, 7

*Crisci v. Security Ins. Co.*,
66 Cal. 2d 425 (1967) ........ 14

*Egan v. Mutual of Omaha Ins. Co.*,
24 Cal. 3d 809 (1979) ........ 8, 14

*Freeman & Mills, Inc. v. Belcher Oil Co.*,
11 Cal. 4th 85 (1995) ........ 10

*Jonathan Neil & Assoc., Inc. v. Jones*,
33 Cal. 4th 917 (2004) ........ 3, 13, 14, 15, 18, 27

*Lance Camper Mfg. Corp. v. Republic Indem. Co. of America*,
44 Cal. App. 4th 194 (1996) ........ 21, 23

*Love v. Fire Ins. Exch.*,
221 Cal. App. 3d 1136 (1990) ........ 7

*MacGregor Yacht Corp. v. State Comp. Ins. Fund*,
63 Cal. App. 4th 448 (1998) ........ 22, 23

*Moradi-Shalal v. Fireman's Fund Ins. Cos.*,
46 Cal. 3d 287 (1988) .......... 28

*N.H. Ins. Co. v. Ridout Roofing Co.*,
68 Cal. App. 4th 495 (1998) .......... 18, 19

*New Plumbing Contractors, Inc. v. Edwards, Sooy & Byron*,
99 Cal. App. 4th 799 (2002) .......... 20, 21, 25, 26

*New Plumbing Contractors v. Nationwide Mutual Ins. Co.*,
7 Cal. App. 4th 1088 (1992) .......... 10

*Noe v. Travelers Ins. Co.*,
172 Cal. App. 2d 731 (1959) .......... 29

*Northwestern Mutual Ins. Co. v. Farmers Ins. Group*,
76 Cal. App. 3d 1031 (1978) .......... 30

*Notrica v. State Comp. Ins. Fund*,
70 Cal. App. 4th 911 (1999) .......... 22

*Rail Services of America v. State Comp. Ins. Fund*,
110 Cal. App. 4th 323 (2003) .......... 24

*Schimmel v. Norcal Mutual Ins. Co.*,
39 Cal. App. 4th 1282 (1995) .......... 16

*Security Officers Serv., Inc. v. State Comp. Ins. Fund*,
17 Cal. App. 4th 887 (1993) .......... 4, 21, 22, 24

*Tricor Cal. v. State Comp. Ins. Fund*,
30 Cal. App. 4th 230 (1994) .......... 22, 23

*Western Polymer Tech. v. Reliance Ins. Co.*,
32 Cal. App. 4th 14 (1995) .......... 9, 19, 20, 29, 30

*Waller v. Truck Ins. Exch.*,
11 Cal. 4th 1 (1995) .......... 11, 12

## STATE STATUTES

1993 Cal. Stat. ch. 228, § 1, p. 1793 .......... 24

## STATE CODES AND REGULATIONS

California Insurance Code

Section 790.03 .......... 28
Section 11651 .......... 27
Sections 11732, 11732.5 .......... 24
Section 11737 .......... 24

California Labor Code

Section 5814 .......... 27, 28

## I. INTRODUCTION

State Compensation Insurance Fund ("State Fund"), a Public Enterprise Fund of the State of California, is the largest writer of workers' compensation insurance in California. The State Fund was created pursuant to article XIV, section 4 the California Constitution to ensure that all California employers would have an available market to purchase workers' compensation insurance. State Fund insures thousands of employers throughout California and, as such, administers claims and provides benefits for scores of injured workers on a daily basis. Consequently, State Fund has a vested interest in those statutory, regulatory and legal authorities affecting the issuance of workers' compensation insurance policies and the administration thereof.

State Fund submits this *amicus curiae* brief because, if affirmed, the District Court's judgment would subject workers' compensation insurers to unpredictable and unwarranted liability, significantly impact the orderly administration of workers' compensation claims and foster an unnecessary conflict between injured workers and California's workers' compensation insurers.

Here, despite the fact that it could prove no true tort liability, American Color Graphics ("ACG") sought and received tort remedies from its workers' compensation insurer, Travelers Property Casualty Company of America ("Travelers"). ACG's claim was predicated solely upon Travelers' handling of *one*

claim filed against ACG by an ACG employee alleging a workplace injury (the "Custodio Claim"). ACG sought and received tort remedies, even though consistent with the express terms of its contract with ACG, Travelers fully defended ACG against the Custodio Claim and successfully resolved the dispute with Ms. Custodio.

Indeed, despite its hindsight assertion of Travelers' "bad faith," the record shows that ACG utilized Travelers' claims handling services for nearly thirteen years prior to the claim at issue and for a number of years thereafter. What is more, the Custodio Claim was but one of *hundreds* handled by Travelers on behalf of ACG. ACG presented no evidence that Travelers' handling of any other claim allegedly caused it damages. ACG also failed to present evidence (or even allege) that Travelers was engaged in any pattern or practice of unreasonable claims handling. Nor did ACG present any evidence that Travelers' representatives engaged in the alleged misconduct in order to benefit Travelers.

State Fund's *amicus* brief shows that, based on the foregoing facts, it was error to permit ACG to seek tort remedies. ACG's legal claim -- at best -- is a claim for breach of contract based upon the implied covenant of good faith and fair dealing. Contract remedies do not include consequential damages, emotional distress damages, *Brandt* fees or punitive damages. *See Archdale v. American Internat. Specialty Lines Ins. Co.*, 154 Cal. App. 4th 449, 466 (2007). While the

California Supreme Court has created a limited exception allowing insurance bad faith that sounds in tort, the "insurance exception" was created specifically to safeguard those unique policy benefits for which insurance is purchased: defense and indemnification. It was not created to govern every aspect of the insurer-insured relationship and certainly does not apply simply because one party to a contract dispute happens to be an insurer.[1]

State Fund respectfully submits that, here, the District Court misapplied this "insurance exception." Because Travelers paid 100% of the Custodio claim, ACG's claim did not implicate a denial of defense and indemnity benefits. Not surprisingly, the record is devoid of any evidence that the Custodio Claim or its resolution exposed ACG to the type of "calamity" or "economic dilemma" warranting application of the "insurance exception." Indeed, all ACG is really alleging is that it was required to pay a higher deductible based on the purported improper resolution of a single claim. This dispute, which in reality is one over whether ACG was liable for too high a deductible with respect to one claim, simply does not fall within the unique interests the "insurance exception" and its

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[1] When calamity strikes or a claim is made, and coverage is wrongfully denied, policyholders may face the "economic dilemma" of having to pay to defend or settle a claim. It is this specific "economic dilemma" which insurance is designed to protect against and the California Supreme Court has held contract damages alone are insufficient to address. *Cates Constr., Inc. v. Talbot Partners*, 21 Cal. 4th 28, 43 (1999); *Jonathan Neil & Assoc., Inc. v. Jones*, 33 Cal. 4th 917, 938-941 (2004).

attendant tort remedies were created to safeguard. Rather, if ACG was able to show that Travelers' actions resulted in a breach of the implied covenant of good faith and fair dealing, such a breach sounded in contract, not tort.

The foregoing limits on the "insurance exception" are not relaxed simply because the matter involves workers' compensation insurance. Certain cases, such as *Security Officers Serv., Inc. v. State Comp. Ins. Fund*, 17 Cal. App. 4th 887 (1993), have extended tort remedies for the breach of the implied covenant of good faith and fair dealing involving workers' compensation claims handling and reserving. But each did so based on *alleged* pervasive or systematic failures that, together with the workers' compensation insurance regime in effect at that time, purportedly *mandated* that the insured pay higher premiums for many years thereafter due to the alleged misconduct.[2]

As explained more fully in Travelers' Opening Brief, the subject insurance regime was subsequently substantially modified and lacks the same application here. Moreover, ACG made no similar allegations of pervasive mishandling and nothing in the *Security Officers* line of cases supports ignoring or expanding the narrow limits the California Supreme Court has placed on the application of the

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[2] *See* Opening Brief of Appellant Travelers Property Casualty Company of America ("Travelers' Opening Brief") at 25 - 26.

"insurance exception" simply because the insurance at issue happens to involve workers' compensation.

Finally, California's workers' compensation insurers have a unique interest in ensuring that the "insurance exception" is properly applied and not expanded by this Court beyond the limits repeatedly imposed by the California Supreme Court. Decisions such as the one below pose a very real "dilemma" to California's workers' compensation insurers. Workers' compensation insurers face a full panoply of laws and regulations designed to protect injured workers. Here, in fact, if Travelers had disputed and litigated Ms. Custodio's claim through hearing and lost, Travelers would have been exposed to significant fines and other penalties imposed by California's workers' compensation system. If the decision below is upheld, bad faith liability will be utilized to second guess the insurer's exercise of its contractual discretion to pay claims. Not only is this inconsistent with the rationale for permitting the tort of insurance bad faith, as explained more fully below, it also creates an irreconcilable tension for California's insurers between injured workers seeking statutory benefits and employers demanding the denial of such benefits.

## II. ARGUMENT

### A. THE UNDERLYING JUDGMENT IMPROPERLY EXTENDS THE APPLICATION OF THE "INSURANCE EXCEPTION"

ACG's suit against Travelers is based solely upon Travelers' payment of a single claim. Moreover, it is undisputed that Travelers fully defended and resolved Ms. Custodio's claim against ACG consistent with the governing insurance contract between the parties. As set forth more fully below, these undisputed facts fail to support application of the limited exception permitting tort damages for breach of insurance contracts.

#### 1. The Insurance Exception Exists to Protect the Insured in Times of Greatest Need

By way of background, a covenant of good faith and fair dealing is implied into all contracts -- including contracts for insurance -- pursuant to which "neither party will do anything which will injure the right of the other to receive the benefits of the agreement." *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 658 (1958). Insurance differs from all other contracts, however, in that breach of the implied covenant in the insurance context may give rise to tort liability whereas in all other contexts a breach is only subject to contractual liability.

This "insurance exception" was not created merely because one party to a contract happens to be an insurer. Rather, it was created to enforce the special nature of certain obligations that are owed under an insurance contract. In particular, insurance is intended to provide benefits which protect an insured at a

time when he or she is most vulnerable, and therefore provides security and peace of mind. *Love v. Fire Ins. Exch.*, 221 Cal. App. 3d 1136, 1148 (1990) ("The bargained-for peace of mind comes from the assurance that the insured will receive prompt payment of money in times of need."). To safeguard these benefits, "special and heightened implied duties of good faith are imposed on insurers and made enforceable in tort." *Id.* In short, courts have created special rules allowing tort damages to protect policyholders from the exceptional losses that can result from a wrongful denial of insurance benefits.

Thus, in a typical tortious breach of the implied covenant case, the plaintiff has purchased either first-party (e.g., health and accident) or third-party (e.g., automobile liability) insurance to protect against a first-party risk, such as major illness, or a third-party risk, such as being sued by someone whom the insured has negligently injured. The gist of the typical case is that the insurer's unreasonable conduct placed the policyholder in an "economic dilemma" by either unreasonably refusing to pay needed medical benefits or by unreasonably refusing to defend or settle a third-party lawsuit.

As an example, in the liability insurance context, the implied covenant requires insurers to accept reasonable settlement offers within the policy limits because of the insured's bargained-for protection from liability. *See, e.g.*, *Comunale*, 50 Cal. 2d at 659 (implied duty to accept reasonable settlement offers

effectuates insured's expectation of protection from liability); *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 819 (1979) (in first-party context, implied covenant protects the peace of mind and security for which disability insurance is purchased).

But merely because a contract involves insurance does not mean that the "insurance exception" applies. The California Supreme Court has consistently distinguished between the unique interests the "insurance exception" was created to protect and ordinary contract disputes.

*Cates Construction, Inc.*, is instructive here. In finding that the "insurance exception" did not apply to a surety bond, the court reviewed California's law regarding insurance bad faith. Based on this review, *Cates* reaffirmed that "the insurance policy cases represent a major departure from traditional principles of contract law," and that "courts [should] exercise great care in considering whether to extend the exceptional approach taken in those cases to another contract setting." 21 Cal. 4th at 46 (quotation marks and citation omitted).

In particular, the court explained that "[b]ecause the covenant of good faith and fair dealing essentially is a contract term that aims to effectuate the contractual intentions of the parties, compensation for its breach has almost always been limited to contract rather than tort remedies." *Id.* at 43 (quotation marks and citation omitted). "[T]his court recognizes only one exception to that general rule:

tort remedies are available for a breach of the covenant in cases involving insurance policies." *Cates Constr., Inc.*, 21 Cal. 4th at 43.

The *Cates* Court explained this exception by noting that "insurance policies are not purchased for profit or advantage; rather, they are obtained for peace of mind and security in the event of an accident or other catastrophe." *Id.* at 44. Thus, "an insured faces a unique 'economic dilemma' when its insurer breaches the implied covenant of good faith and fair dealing. Unlike other parties in contract who typically may seek recourse in the marketplace in the event of a breach, an insured will not be able to find another insurance company willing to pay for a loss already incurred." *Id.* (citations omitted). The *Cates* Court thus sought to distinguish between the "economic dilemma" that can result from a wrongful denial of unique insurance policy benefits, and other financial hardships.

As the *Cates* Court explained, not all financial hardships warrant the protections of tort remedies. Rather, there is a distinction between "that type of unique 'economic dilemma' [which insurance is purchased to protect] [and] the ordinary sort of situation in which breach of a commercial contract may have merely adverse financial significance to the nonbreaching party." *Id.* at 54; *see also Western Polymer Tech. v. Reliance Ins.* Co., 32 Cal. App. 4th 14, 27 (1995) ("a liability insurance policy's purpose is to provide the insured with a defense and indemnification for third party claims within the scope of the coverage purchased,

and not to insure the entire range of the insured's well-being."); *New Plumbing Contractors v. Nationwide Mutual Ins. Co.*, 7 Cal. App. 4th 1088, 1096 (1992) (characterizing "peace of mind and security [as] the principal benefits for the insured, [for which] the courts have imposed special obligations . . . .").

In short, California courts uniformly restrict the availability of tort remedies for breach of the implied covenant to cases in which the insurer's misconduct affected benefits necessary to protect the subject matter of insurance -- the insured's peace of mind and protection from calamity.

### 2. **The Insurance Exception is Inapplicable Where the Unique Interests it was Intended to Protect Are Not Implicated**

Recognizing the narrow limits of the "insurance exception," the California Supreme Court has clearly stated that tort damages are available pursuant to the "insurance exception" *only* where necessary to protect the defense and indemnity benefits for which insurance is purchased -- even where an insurer's alleged misconduct caused other extra-contractual harm. *See Freeman & Mills, Inc. v. Belcher Oil Co.*, 11 Cal. 4th 85, 93 (1995) (reviewing "opinions of this court [which] indicate a continuing reluctance . . . to authorize tort recovery for noninsurance contract breaches.").

Indeed, the California Supreme Court has rejected a number of attempts to expand bad faith tort liability and apply it outside the context of a failure to defend

or indemnify. For example, in *Waller v. Truck Ins. Exch.*, 11 Cal. 4th 1, 35 (1995), the California Supreme Court held that an insured may not maintain a claim for breach of the implied covenant of good faith and fair dealing unless the insurer has unreasonably denied or withheld "policy benefits [that] are due under the contract."

At issue in *Waller* was an insurer's refusal to defend claims asserting that the insured (a company known as Marmac) and various of its shareholders had acted wrongfully in terminating Marmac's former president. *Id.* at 13. Marmac claimed that Truck's refusal to defend constituted tortious bad faith. *Id.* at 14. The *Waller* Court disagreed. Reasoning that the underlying claims constituted non-covered business disputes arising from intentional acts, the court held that "if there is no *potential* for coverage and, hence, no duty to defend under the terms of the policy, there can be no action for breach of the implied covenant of good faith and fair dealing because the covenant is based on the contractual relationship between the insured and insurer." *Id.* at 36 (emphasis in original).

The *Waller* Court did *not* conclude that Truck had acted properly in its dealings with Marmac. To the contrary, the court acknowledged allegations that Truck had delayed its investigation of Marmac's insurance claim, and had misled Marmac into believing that it would provide a defense. *Waller*, 11 Cal. 4th at 12-13. But, the court reasoned, such actions did not result in any denial of policy

benefits -- since no policy benefits were owed on the underlying claim -- so that there was no need to permit a tort recovery. In such cases, while an insured may file a complaint with the Insurance Commissioner alleging insurer misconduct that implicates duties unrelated to policy benefits owed, such conduct will not support a claim for tortious bad faith. *Id.* at 36.

In reaching its conclusion, the California Supreme Court reasoned that although tort remedies may be appropriate where the insurer unreasonably withheld defense and indemnity benefits purchased to assure peace of mind and protection from calamity, tort damages are inappropriate where no such benefits are implicated. Because mere business disputes between the insurer and policyholder can be resolved under ordinary contract principles, the broad protection established in tort law is unnecessary. Commercial disputes over the costs of insurance cannot be cast as a claim for bad faith when the insured admittedly received all the defense and indemnification it bargained for in purchasing its insurance.

Once again in *Jonathan Neil & Associates*, the California Supreme Court revisited this issue and emphasized that the narrow insurance exception only allows an insured to seek tort damages for the breach of specific duties occurring "in the context of an insurance company's failure to properly settle a claim against

an insured, or to resolve a claim asserted by the insured." *Jonathan Neil & Assoc.*, 33 Cal. 4th at 923.

At issue in *Neil* was the availability of tort remedies for an insurance company's breach of the implied covenant of good faith and fair dealing in a situation where the insurance company "retroactively overcharges a premium it knows it is not owed." *Id.* at 923. Ultimately, the *Neil* Court held that tort remedies for breach of the implied covenant of good faith and fair dealing are unavailable regardless of the motive for the insurer's misconduct. *Id.* at 941.

The *Neil* action arose out of a premium audit dispute where, following expiration of the insurance policy, the insurer assessed an additional premium. The insured, the Joneses, declined to pay the audited premium, and a collection agency sued the Joneses for the balance due. The Joneses cross-complained against the insurer alleging that it had retroactively *and knowingly* charged a substantially higher premium than was actually owed, and was therefore liable for tortious breach of the covenant of good faith and fair dealing and for fraud.

In reaching its decision that these tort remedies were inapplicable, the California Supreme Court reviewed the history of the doctrine of the implied covenant of good faith and fair dealing in insurance contracts and its use to recover tort and punitive damages in certain, limited, contexts.

The *Neil* Court highlighted decisions such as *Egan*, 24 Cal. 3d 809 and *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425 (1967), which had been based upon the quasi-public nature of insurance and the reality that the promises to defend and indemnify are made with the expectation that they will be fulfilled at a time when the policy holder is in "*extremis*." It cited the explanation in *Egan* that in making such promises the insurer is a quasi-fiduciary who must give as much consideration to the policyholder's interests as its own and confirmed that the policyholder's need to receive promised policy benefits justified tort damages "[w]hen the insurer unreasonably and in bad faith withholds payment of [a] claim of its insured . . . ." *Egan*, 24 Cal. 3d at 818.

The *Neil* Court next identified several additional critical factors weighing against the imposition of tort remedies even when an insurance company knowingly retroactively overcharges a premium. *See* 33 Cal. 4th at 938-939. First, explained the court, deterrents such as market competition and government regulation limit the insurer's ability to charge excessive premiums. Second, the billing dispute does not by itself deny the insured the promised benefits for which the insurance policy was purchased: the security against losses and third-party liability. Thus, the premium dispute does not create the type of "*extremis*" that might provide the justification for turning an ordinary breach of contract into a tortious breach of contract. Third, the billing dispute does not require the insured

to prosecute the insurer in order to enforce its rights. Fourth, traditional tort remedies (including malicious prosecution, defamation, and intentional interference with prospective economic advantage) may be available to the insured who is wrongfully billed a retroactive premium. *Jonathan Neil & Assoc.*, 33 Cal. 4th at 939.

Ultimately, the court concluded *that even under circumstances where there is a knowing over-charge of premium, the extension of tort remedies is unjustified* because the insureds did not find themselves in the "same vulnerable position as those who suffer from the insurer's bad faith claims and settlement practices[,]" "were not denied the benefits of the insurance policy, were not required to prosecute the insurer to vindicate their contractual rights, and had available various administrative, contractual, and tort remedies." *Id.* at 941.

*Waller* and *Neil* thus not only clarify what constitutes insurer bad faith for which tort damages may be awarded, but also what does not. Under these California Supreme Court holdings, a dispute arising from the insured's business relationship with its policyholder will not support imposition of tort damages. This is because premiums are not policy benefits but rather are an aspect of the business relationship between the insurer and the insured. *See also Camelot by the Bay Condominium Owners' Assn. v. Scottsdale Ins. Co.*, 27 Cal. App. 4th 33, 52-54 (1994) (rejecting bad faith claim and emphasizing that the implied covenant

applies only to duties that are coextensive with the four corners of the insurance contract); *Schimmel v. Norcal Mut. Ins. Co.*, 39 Cal. App. 4th 1282, 1285-86 (1995) (no tort claim for nonrenewal of liability policy).

Measured against these principles, there is no basis for applying the "insurance exception" to ACG's claim and permitting ACG to obtain tort and punitive damages. Here, ACG purchased workers' compensation insurance from Travelers. Travelers did not deny ACG coverage for the claim and subject it to an attendant "economic dilemma." To the contrary, Travelers *fully defended* ACG against Ms. Custodio's workers' compensation claim. (Reporter's Transcript ("RT") 954:19-955:2, 959:20-24, 1230:19-25, 1342:16-20/Excerpts of Record ("ER") 01726-27, 1731, 1758, 1775.) What is more, despite ACG's contention that it was unnecessarily subject to liability for its deductible (to Travelers), no evidence was presented that ACG paid or reimbursed Travelers for any monies. The record shows *Travelers paid* for the Custodio claim (and only paid approximately $40,000 at that). (ER 01509, 1558- 64, 1595-96.) Even if Travelers had denied the claim, the ACG would have been liable for defense costs under the program and no evidence was presented that Ms. Custodio -- who had already hired a lawyer before the claim was accepted -- would have dropped her claim. (RT 591:17-20/ER 01691.)

It is apparent why these facts do not support a claim of breach of the implied covenant of good faith and fair dealing, which would subject the insurer to tort and punitive damages. ACG certainly is not contending that Travelers' action created an "economic dilemma" or anything akin to it. Assuming that it even reimbursed Travelers for the deductible, ACG is essentially disputing the amount of the deductible it had to pay based on the resolution of this one claim. As a result, this dispute -- over one aspect of the price of its insurance -- differs in no respect from the price dispute which could result from any other type of contract (for example, a services agreement or automobile lease) pursuant to which fees or costs are calculated based on events which occur after the contract is executed (for example, based on the amount and type of services provided or mileage on and damage to a leased car).

Finally, it is also important to keep in mind that even without access to tort remedies, ACG could still -- upon proper proof -- obtain contractual remedies for breach of the implied covenant of good faith and fair dealing. Theoretically, in that circumstance, ACG would be able to recover such breach of contract damages such as a refund of (or would be relieved from paying) any amounts related to the claim pursuant to the contract.

In sum, abundant California caselaw makes clear that the extraordinary relief of tort damages is unwarranted for such a contractual breach. Tort damages have

been permitted where an insurer wrongly denies the special benefits owed by insurers (and in *no other contexts*) precisely because those policy benefits are unique and differ from other contractual obligations. *See Cates Constr., Inc.*, 21 Cal. 4th at 43-44. ACG was not denied these unique policy benefits and was not faced with the "economic dilemma" of an insurer failing to defend or resolve a covered claim. *See Jonathan Neil & Assoc.*, 33 Cal. 4th at 938-41. As such, this case falls well outside the scope of the "insurance exception," so that tort and punitive damages should have been precluded.

### 3. Tort Liability Cannot Be Imposed Based on the Exercise of Express Contractual Rights

Where a policyholder gives an insurer the express right to settle a claim, such a right is not limited by the implied covenant of good faith and fair dealing, even where the settlement implicates the insured's deductible layer (as was the case here). *N.H. Ins. Co. v. Ridout Roofing Co.*, 68 Cal. App. 4th 495, 505 (1998). In *Ridout*, the court found that an insurer's exercise of its express right to settle, even within the insured's deductible, could not violate the implied covenant of good faith and fair dealing:

> We hold that this general rule . . . applies with equal force in the insurance context. The parties to this insurance contract gave the insurer the express right to settle claims and, if such settlements included the insured's deductible, to thereafter seek reimbursement from the insured. The exercise of such an express grant

> cannot, in our view, be limited by the implied covenant of good faith and fair dealing.

*Ridout Roofing Co.*, 68 Cal. App. 4th at 502.

In reaching its conclusion the *Ridout* Court noted that California law is unequivocal that the implied covenant of good faith and fair dealing cannot be used to modify the express terms of a contract. *Id.* at 504 (*citing Carma Developers v. Marathon Dev. Cal.,* 2 Cal. 4th 342, 374 (1992)). *Ridout's* holding is consistent with numerous California authorities recognizing that insurers have discretion in settling claims -- a discretion that is not altered by the breach of implied covenant of good faith and fair dealing -- even when the insured complains that the settlement may affect other interests.

For example, in *Western Polymer Technology*, 32 Cal. App. 4th 14, the policyholder contended that its insurer's settlement of a claim within the policy limits -- and over the policyholder's objection -- adversely effected its business relationship. In rejecting a claim for breach of the implied covenant the *Western Polymer* Court explained that the insured's additional interest -- its business reputational interest -- did not trump the insurer's express right under the contract to settle claims. Even if real, that interest "differ[s] in kind and character" from the types of injury which could provide the basis for a breach of the implied covenant. *Id.* at 27. Ultimately, the court found that because the insured obtained defense

and indemnity protection against the claim, there was no denial of policy benefits. Thus, there could be no breach of the implied covenant. *See id.*

Indeed, this right to settle controls even where the insured claims that the insurer breached the implied covenant of good faith by entering into an improper settlement which resulted from an inadequate defense of the claim (as ACG asserts here). Specifically, in *New Plumbing Contractors, Inc. v. Edwards, Sooy & Byron*, 99 Cal. App. 4th 799 (2002) (hereinafter "*New Plumbing*"), the insured brought a malpractice claim against a firm hired by its insurer to defend the insured against a claim covered by a general liability insurer. Much like ACG, the insured, New Plumbing, contended that the defendant law firm "did not notify [New Plumbing] of the settlement negotiations, and it failed to properly defend the action, *ignoring valid defenses that would have absolved New Plumbing of any liability.*" *Id.* at 801 (emphasis added). New Plumbing further alleged that because of the settlement, "it had to pay higher premiums, accept lower coverage and higher deductibles, and deal with financially weaker carriers to obtain insurance thereafter." *Id.* The defendant argued that New Plumbing could not establish causation or damages "because the insurer had the absolute right to settle the case . . . ." *Id.*

The *New Plumbing* Court agreed, respecting the insurer's right to settle. Specifically, the court rejected the plaintiff's claim and held that "[u]nder a policy provision giving an insurance company discretion to settle as it sees fit, the insurer

is 'entitled to control settlement negotiations without interference from the insured,' and generally it has no liability to the insured for settling within the policy limits." *New Plumbing*, 99 Cal. App. 4th at 802 (citation omitted).

Here, there is no question that Travelers had the "*right* to investigate and settle" claims, proceedings, or suits against ACG -- even claims falling solely within ACG's deductible limit. (ER 01300, 1493-97.) Moreover, there is no provision in the policy limiting Travelers' discretion or requiring Travelers to even notify ACG prior to settlement. (ER 01501; RT 1203:25-1206:15/ER 01750-53.) In fact, ACG had no contractual right to approve settlement. (ER 01493-97.) Thus, to the extent that Travelers has been penalized for pursuing its rights under its contract with ACG, the underlying decision also fails to adhere to the California Supreme Court's instruction that the implied covenant cannot be read to prohibit a party's rights under a contract -- in this instance, the insurer's right to control claims resolution.

#### 4. The *Security Officers* Line of Cases Are Inapplicable Here

ACG will likely contend that its case is similar to prior decisions wherein a claim for breach of the implied covenant of good faith and fair dealing was extended to encompass allegations of mishandling and over-reserving of workers' compensation claims. *See, e.g., Security Officers Serv.*, 17 Cal. App. 4th 887; *Lance Camper Mfg. Corp. v. Republic Indem. Co. of Am.*, 44 Cal. App. 4th 194

(1996); *MacGregor Yacht Corp. v. State Comp. Ins. Fund*, 63 Cal. App. 4th 448 (1998); *Notrica v. State Comp. Ins. Fund*, 70 Cal. App. 4th 911 (1999); *Tricor Cal. v. State Comp. Ins. Fund*, 30 Cal. App. 4th 230 (1994). While State Fund vehemently disagrees with the plaintiffs' allegations in those cases and the holdings of the courts therein, the allegations made by each of the plaintiffs in those cases are markedly different than ACG's allegations here.

Fundamentally, each of the *Security Officers* line of cases alleged that *numerous* claims were mishandled, that numerous claims were over-reserved, that the insurer had an improper reserving standard (that could impact the reserving of all claims) and/or that the insurer had a financial interest in mishandling claims because the premiums charged by the insurer increased due to the mishandling and over-reserving of claims.

For instance, in *Security Officers*, the court noted that the plaintiff alleged that the implied covenant was breached "by an *interwoven pattern* of failing to pay claims promptly, defend them diligently, or assign them reasonable reserves . . . ." 17 Cal. App. 4th at 893 (emphasis added). Similarly, in *Notrica*, the insured sued based on "case reserve and claims handling *policies and practices*" which caused its premiums to increase. 70 Cal. App. 4th at 918 (emphasis added). And, in *Lance Camper*, the insured was "challenging *the claims handling practices* that increased the Insurer's reported losses, which resulted in higher premiums, higher

reserves, and lower dividends." 44 Cal. App. 4th at 203 (emphasis added). Not surprisingly, in *Tricor,* the court found that evidence of mishandling to the insured's claims, *if shown as a pattern*, would be relevant to the insured's claims. 30 Cal. App. 4th at 238.[3]

In addition to the alleged pervasive claims mishandling and over-reserving, each decision was also based on the applicable insurance regime and rating system governing workers' compensation, under which the alleged misconduct "inextricably" led to the insured having to pay higher premiums for its entire workers' compensation program. As explained by *Security Officers* at page 891, the insured's premium was determined by the "rating bureau" who factored in information regarding the type of work being performed, the insured's payroll and loss experience:

> Plaintiff's policy premiums are determined by the rating bureau, as a function of the "manual rate" for the industry in question [internal citations omitted], the employer's annual payroll, and its loss "experience rating," as modified with regard to the number of claims outstanding at the end of the year, and the amount of reserves SCIF has established for those unresolved claims. [citing the relevant experience rating plan].)

Based on these regulations governing workers' compensation insurance pricing, *Security Officers* noted that the "insurer's failure to act reasonably when adjusting claims *automatically* subjects the insured to greater financial obligations

[3] *See also MacGregor Yacht Corp.*, 63 Cal. App. 4th at 451 (alleged mishandling of "many of the workers' compensation claims").

in the form of increased premium rates." 17 Cal. App. 4th at 897 (emphasis added). The mandatory impact on premium was essential to the court's conclusion that, "*under an insurance regime* in which the insured's annual claims experience *inexorably influences* its premiums, the insurer may be liable if it processes claims and sets reserves without good faith regard for their impact on the insured's premiums and potential dividends." *Id.* at 890 (emphasis added).

As explained in Travelers' Opening Brief at pages 25 - 26, there is no such mandatory impact on premium here, not only because of the nature of ACG's policy, but also because California abandoned this "insurance regime" more then a decade ago when the legislature amended Insurance Code section 11732 and related regulations. *See Rail Services of America v. State Comp. Ins. Fund*, 110 Cal. App. 4th 323, 334 (2003) (law giving only Insurance Commissioner authority to set premium rates repealed in 1993); 1993 CAL. STAT. ch. 228, § 1, p. 1793. As a result, insurers are free to set premium rates as they see fit so long as they are not discriminatory nor threaten the solvency of the insurer. *See* CAL. INS. CODE §§ 11732, 11732.5 and 11737.

Here, ACG's allegation that it was required to make a higher, single deductible payment with no evidence of increased premiums is dramatically different from the allegations made by each of the plaintiffs' in the *Security Officers* line of cases. There is no allegation of pervasive or systematic claims

mishandling leading to increased premiums. Likewise, there is no claim of improper over-reserving of claims to increase retrospectively rated premiums or decrease policy dividends. Nor is there an allegation that Travelers' representatives engaged in the alleged misconduct in order to benefit Travelers.

Moreover, whereas the insured's premium in *Security Officers* was allegedly automatically determined by the handling of claims, there are no such premium allegations here. Indeed, ACG, unlike the insured in *Security Officers*, negotiated the deductible before purchasing the policy and prior to Travelers' handling of the claim. ACG could have negotiated a different arrangement giving it more control over settlement of claims or even chosen to do business with another carrier. It did neither.

Indeed, ACG's claim here bears a far greater resemblance to the claim in *New Plumbing* discussed above than to *Security Officers*. Like ACG here, the insured in *New Plumbing* alleged that a single claim was improperly settled after the insured's hired counsel "failed to properly defend the action, ignoring valid defenses that would have absolved New Plumbing of any liability." *New Plumbing Contractors, Inc.*, 99 Cal. App. 4th at 801. Similarly, New Plumbing alleged that the settlement had negative financial implications. But unlike ACG, who theoretically only had liability for a higher deductible payment on one claim, New Plumbing alleged that "it had to pay higher premiums, accept lower coverage and

higher deductibles, and deal with financially weaker carriers to obtain insurance thereafter." *Id.* Nevertheless, despite these allegations, the *New Plumbing* Court found no breach of the implied covenant.

The court in *New Plumbing* also rejected New Plumbing's claim that its suit should be governed by *Security Officers*. New Plumbing found that *Security Officers*' holding rested on allegations that the insured was "not diligent[] [in] paying claims and then setting artificially high reserves to compensate, with the result the insured's premiums go up . . . ." *Id.* at 802. Finding no similar allegations, the court refused to extend the same finding regarding breach of the implied covenant.

No such similar allegations are found here either. There is no evidence that ACG's premium increased or that it was required to pay any additional amounts for the way in which the Custodio Claim was resolved. As stated above, the current rating system also does not mandate that ACG's premium increase based on how the Custodio Claim was resolved. Moreover, no "pattern and practice" or systemic deficiency in paying claims was alleged. In short, ACG's claim is manifestly different than the claim made in *Security Officers*.

Ultimately, the Custodio Claim is but one of 838 workers' compensation claims ACG submitted to Travelers between January 2001 to June 2005. (RT 1539:19-1540:20/ER 01793-94.) Total incurred losses during this same period

were in the neighborhood of "$4 million." (RT 1179:15-23, 1180:16-19/ER 01744-45.) Looking at the totality of the insurance relationship between ACG and Travelers it is hard to fathom how, even if the Custodio Claim was improperly resolved, ACG was denied policy benefits akin to creating a "calamity" or "economic dilemma." At most, ACG was liable for having to pay a deductible with respect to one claim. If the deductible liability was in-fact unwarranted, ACG had, as the *Neil* Court advised, other remedies. *See* 33 Cal. 4th at 939.

### B. THE DISTRICT COURT'S DECISION NEGATIVELY IMPACTS THE ADMINISTRATION OF WORKERS' COMPENSATION CLAIMS AND FOSTERS UNNECESSARY CONFLICTS BETWEEN INSURERS, INJURED WORKERS AND EMPLOYERS

Workers' compensation and workers' compensation insurance is heavily regulated. Among other things, insurers face a host of laws and regulations designed to protect injured workers. The decision below implicates that system because arguably it gives insured employers the right to demand that an insurer deny an injured workers' claim or face bad faith damages. This ignores the insurer's role as the administrator of workers' compensation claims, (*see, e.g.*, CAL. INS. CODE § 11651), and creates an irreconcilable conflict for the insurer.

For example, by statute, a workers' compensation insurer is directly liable to the claimant, including a 10 to 25% percent penalty, if it unreasonably delays or refuses to pay benefits that are due. CAL. LAB. CODE § 5814. As happened here,

an insurer who pays a claim on its insured's behalf (per the insurance contract) may be forced to fend off a suit by the insured who, though receiving policy benefits, is disgruntled by the cost of its insurance. An insurer who, instead, withholds benefits in order to placate the insured and minimize the insured's costs, will face the imposition of a penalty of 10 to 25% for every payment it unreasonably withholds. *Id.*

It was precisely such conflicting duties, where insurers were subject to multiple pieces of litigation, "coerced settlements" and "confusion and uncertainty" that caused the Supreme Court to limit a third-party's private right of action under California Insurance Code section 790.03. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 46 Cal. 3d 287, 304-08 (1988). And indeed, in the workers' compensation context, similar concerns led Justice Tobriner to remark that permitting suits outside of the workers' compensation system -- for conduct occurring related to that system -- would undermine the "uniform and exclusive" application of the workers' compensation laws:

> [W]e must point out that if delay in medical service attributable to the carrier could give rise to independent third party court actions, the system of workmen's compensation could be subjected to a process of partial disintegration. . . . The uniform and exclusive application of the law would become honeycombed with independent and conflicting rulings of the courts. The objective of the Legislature and the whole pattern of workmen's compensation could thereby be partially nullified.

*Noe v. Travelers Ins. Co.*, 172 Cal. App. 2d 731, 737 (1959).

These conflicting duties are also why the line between what constitutes a "breach of contract" and what constitutes a "tortious breach of the implied covenant of good faith and fair dealing" must be maintained and not loosely blurred. Workers' compensation insurers who have been given the right to settle claims against their insured should not be subject to bad faith liability when they settle a claim by an employee asserting a workplace injury. To hold otherwise may make those insurers more reluctant to settle with injured workers out of fear that their decisions will later be second-guessed. The underlying judgment here represents exactly such subjective second-guessing where Travelers -- based on the resolution of *one* out of hundreds of claims -- found itself facing tort liability.[4]

Indeed, the foregoing conflict was observed by the *Western Polymer* Court, which noted that if permitted, the insured's argument that settlement of a claim within policy limits could give rise to breach of the implied covenant "would place insurers in an untenable position." 32 Cal. App. 4th at 27. This results from the fact that insurers "already must face bad faith liability for unreasonably refusing a settlement offer within their policy limits [citation omitted]" and under the insured's "extension of potential bad faith liability to include" the settlement

[4] While *Security Officers* rejected the notion that such a conflict occurs, it did so in the context of allegations of pervasive claims mishandling. Again, there are no such allegations here.

"liability insurers always would be faced with a dilemma as to settlements." *Id.* at 27-28.

Given that ACG's insurance contract contained a deductible, had Travelers not settled the Custodio claim and had Ms. Custodio prevailed, one can rest assured that ACG would have questioned why the settlement was not accepted. This business reality presents the same type of dilemma highlighted by the *Western Polymer* case, and is why insurers -- including workers' compensation insurers -- are given great discretion in resolving claims against their insureds. *See Northwestern Mutual Ins. Co. v. Farmers Ins. Group*, 76 Cal. App. 3d 1031, 1043 (1978) ("insurer is entitled to control defense of any action, including settlement negotiations").

## III. CONCLUSION

For the foregoing reasons, State Fund respectfully submits that, save for the award of nominal damages, the judgment against Travelers should be reversed.

Dated: February 1, 2008 STATE COMPENSATION INSURANCE FUND

By:

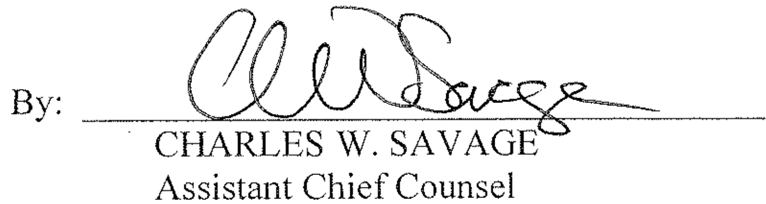
CHARLES W. SAVAGE
Assistant Chief Counsel

**CERTIFICATE OF WORD COUNT**

**(FED. R. APP. P. 32(a)(7)(C))**

I certify that pursuant to Federal Rule of Appellate Procedure 32(a)(7)(C), the attached brief contains 6,989 words, excluding the Corporate Disclosure Statement, Table of Contents, Table of Authorities and this Certificate, in proportionately spaced typeface of 14 points as counted by the word-processing program used to generate the brief.

Dated: February 1, 2008 STATE COMPENSATION INSURANCE FUND

By: 

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## CERTIFICATE OF SERVICE

I, Mary E. Leija-Tosetti, hereby declare:

I am a citizen of the United States. My business address is 1275 Market Street, San Francisco, California. I am employed in the County of San Francisco, California where this mailing occurs. I am over the age of 18 years, and not a party to the within action. I am readily familiar with my employer's normal business practice for collection and processing of correspondence for mailing with the U.S. Postal Service, and that practice is that correspondence is deposited with the U.S. Postal Service the same day as the day of collection in the ordinary course of business.

On the date set forth below, following ordinary business practice, I caused to be served by mail the foregoing document(s) described as:

**STATE COMPENSATION INSURANCE FUND'S AMICUS CURIAE BRIEF IN SUPPORT OF APPELLANT TRAVELERS PROPERTY CASUALTY COMPANY OF AMERICA (BRIEF SUPPORTING REVERSAL)**

on said date at my place of business, a true copy thereof enclosed in a sealed envelope prepaid for first-class mail for collection and mailing that same day in the ordinary course of business, addressed to the parties as follows:

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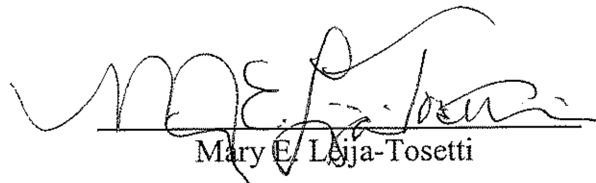
I declare under penalty of perjury under the laws of the United States of America that the foregoing is true and correct, and that this declaration was executed on February 1, 2008 at San Francisco, California.



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