BY JEREMY A. LAWRENCE

Rules Governing Defense Coverage in an Insurance Policy

WHEN AN INSURANCE COMPANY REFUSES to defend a policyholder in a lawsuit, the policyholder should act quickly to secure defense coverage. Although California courts have developed a number of rules designed to resolve defense coverage disputes in favor of general liability policyholders, a dilatory approach rarely benefits the policyholder in cases in which litigation over the insurer's duty to defend is warranted.[1] Once informal avenues of relief are exhausted, there should be no delay in pursuing litigation against the insurer if the policyholder believes that he or she is entitled to defense coverage and if the defense costs are large enough to justify the litigation costs.

The foundational rule of defense coverage is that insurers must defend any lawsuit that even "'potentially seeks damages within the coverage of the policy.'"[2] The plaintiff's factual allegations against the policyholder are taken as true, and if those allegations can be construed to fall within the scope of the insurance policy's coverage, the insurer must defend the lawsuit. Coverage is available even if the plaintiff in the underlying lawsuit does not plead all the elements of a covered cause of action, as long as the factual allegations potentially fall within the scope of the policy. "[I]t is not the form or title of a cause of action that determines the carrier's duty to defend, but the potential liability suggested by the facts alleged…."[3]

When there is a factual gap in the allegations, the policyholder may be aware of evidence outside the pleadings that potentially brings the claim within the scope of the policy. In this case, the policyholder should submit the evidence to the insurer at the earliest possible time because the insurer must consider it when deciding whether to provide coverage. It does not matter if the insurer does not believe the policyholder, since the insurer still needs to provide defense coverage. As the court of appeal has explained, "[A]n insurer who simply denies coverage based upon its uncorroborated belief that the information in its possession may be fabricated, does so at its own risk…."[4]

In cases in which there may be conflicting evidence that may or may not result in coverage depending on how the evidentiary conflicts are resolved, these factual disputes must be resolved in favor of the policyholder.[5] This rule prevents insurers from prejudicing the policyholder by seeking factual determinations that may be used against the policyholder in the underlying lawsuit and by forcing the policyholder "to fight a two-front war" at a time when the policyholder's attention should be focused on defending against potential liability rather than fighting to secure insurance coverage.[6]

The insurer's defense obligations continue until the insurer identifies evidence conclusively showing that there is no possibility that the claim will be covered, at which time the insurer can seek a judicial decision authorizing it to stop paying the policyholder's defense costs. An insurer also may try to justify a failure to defend by relying on evidence developed in the underlying case that the insurer believes shows the claim is not covered. The insurer then argues that there was never a potential for coverage. However, when an insurer identifies new evidence that was not previously available, the duty to defend is "extinguished only prospectively and not retroactively."[7] There is a real risk, however, that the subsequently developed evidence will color the court's views on the merits, and, if a claim is ultimately not covered, a court may be more inclined to conclude that the claim was never even potentially covered.

In consideration of these rules, policyholders typically should seek an early decision on defense coverage, and insurers should be prepared to defend a lawsuit at its inception or face bad faith claims.

Because there are rarely any downsides to pursuing an early coverage decision, policyholders would be wise not to wait.

Generally, the plaintiff's allegations against the policyholder should provide enough information to create a potential for coverage. If the allegations are insufficient, the policyholder often has access to additional evidence that can establish defense coverage. Given that defense coverage often can be established at the outset of the lawsuit, there is little reason for the policyholder to wait before securing insurance coverage. The longer a policyholder waits, the greater the opportunity for the insurer to develop facts and arguments that ultimately may bar coverage. An additional benefit of an early coverage decision is that the court will not be biased by later developments in the underlying lawsuit. Although courts are technically required to review the allegations and evidence known to the insurer at the time when the policyholder first requested defense coverage, in practice, a judge's hindsight can be 20/20. Because there are rarely any downsides to pursuing an early coverage decision, policyholders would be wise not to wait. ■

[1] In addition to the rules discussed in this article, other policyholder-friendly rules include the rules of construction under which coverage provisions are construed broadly, exclusions are construed narrowly, and ambiguities are resolved in favor of the reasonable expectations of the policyholder. *E.g.*, MacKinnon v. Truck Ins. Exch., 31 Cal. 4th 635, 648 (2003); AIU Ins. Co. v. Superior Court, 51 Cal. 3d 807, 822 (1990).

[2] Montrose Chem. Corp. v. Superior Court, 6 Cal. 4th 287, 295 (1993) (quoting Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 275 (1966)).

[3] CNA Cas. of Cal. v. Seaboard Sur. Co., 176 Cal. App. 3d 598, 609 (1986).

[4] Amato v. Mercury Cas. Co., 18 Cal. App. 4th 1784, 1792 (1993).

[5] Montrose, 6 Cal. 4th at 304.

[6] Haskel, Inc. v. Superior Court, 33 Cal. App. 4th 963, 979 (1995).

[7] Buss v. Superior Court, 16 Cal. 4th 35, 46 (1997).

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