Point

The Duty to Defend

Identifying a Wrongful Denial

By Dominic Nesbitt and Gary Osborne

Counterpoint: *Want to hear the defense's take? Keep a look out for the other side of this argument in the November/December 2016 issue of* San Diego Lawyer.

Exactly 50 years ago, the California Supreme Court laid down the standard for determining whether a liability insurer owes a duty to defend a third-party lawsuit filed against its insured. The Court held that an insurer "must defend a suit which potentially seeks damages within the coverage of the policy" (*Gray v. Zurich Ins. Co.*, 65 Cal.2d 263, 275 [1966]).

Over the years since Gray, the California Supreme Court has repeatedly affirmed the "potential for coverage" standard, making clear that an insurer will only be relieved of a duty to defend if the third-party complaint can "by no conceivable theory" raise a "single issue" that would bring it within the policy coverage. (*Montrose Chem. Corp. v. Superior Ct.*, 6 Cal.4th 287, 300 [1993]). Moreover, insofar as what an insurer must consider in evaluating whether there exists a "potential for coverage," the California Supreme Court has made clear that an insurer must consider all known facts, including facts *extrinsic* to the third-party complaint. See *Scottsdale Ins. Co. v. MV Transp.*, 36 Cal.4th 643, 655 (2005).

Despite this black-letter law, certain liability insurers in California continue to disclaim defense obligations based on arguments that run afoul of the potential for coverage standard. Five of these arguments are described below.

1. The Covered "Cause of Action" Argument

Liability insurers will sometimes deny a defense obligation on the ground that the third-party complaint filed against the insured does not allege a "cause of action" covered by their policy. For example, even where a complaint includes factual allegations of slander or libel (an offense typically covered by a standard CGL policy), an insurer may deny it owes a defense if no formal cause of action labeled "libel," "slander" or "defamation" has been pled.

Such a denial may well be wrongful. California law is clear that the duty to defend turns on the *facts* pled, or otherwise known to the insurer, and not on which formal causes of action the plaintiff's attorney has chosen to plead in the complaint. See *Scottsdale, supra,* 36 Cal.4th at 654 ("[T]hat the precise causes of action pled by the third party complaint may fall outside policy coverage does not excuse the duty to defend where, under the facts alleged, reasonably inferable, or otherwise known, the complaint could fairly be amended to state a covered liability.").

2. The "All Elements" of a Covered Claim Argument

Another related argument made by certain liability insurers is that they owe no duty to defend unless the third-party complaint alleges "all essential elements" of a covered claim. However, there is no such requirement under California law. See *Barnett v. Fireman's Fund Ins. Co.*, 90 Cal.App.4th 500, 510 (2001) (rejecting the insurer's argument that a plaintiff must allege "all of the elements" of a covered cause of action in order to trigger the duty to defend).

3. The "Gravamen" of the Complaint Argument

Insurers will sometimes take the position that no defense is owed where the gravamen of the third-party complaint involves uncovered injuries and claims. Such an argument, however, cannot be squared with the California Supreme Court's affirmation in *Montrose, supra,* that an insurer will be relieved of its duty to defend only if the complaint can by no conceivable theory raise a "single issue" within the policy coverage.

Courts that have considered the gravamen argument made by insurers have soundly and consistently rejected it. See *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal.4th 1076, 1084 (1993) (rejecting insurer's argument that certain alleged misconduct "could not possibly give rise to liability" because other non-covered misconduct was the "dominant factor" in the case); see also *Pension Trust Fund for Operating Engineers v. Federal Ins. Co.*, 307 F.3d 944, 951 (9th Cir. 2002) ("California courts have repeatedly found that remote facts buried within causes of action that may potentially give to coverage are sufficient to invoke the defense duty.").

4. The "Insured Is Not Liable" Argument

Some insurers will argue that where the insured has a cast-iron defense (e.g., a statute of limitations defense) against the third-party complaint, it follows that the insured faces no potential for covered liability, and therefore no duty to defend is owed. This argument turns the entire concept of the duty to defend on its head and has been rejected by courts and leading commentators.

Simply stated, an insured purchases and expects insurance protection against both

valid *and invalid* claims. See *Horace Mann, supra*, 4 Cal.4th at 1086 ("An insured buys liability insurance in large part to secure a defense against *all* claims potentially within policy coverage, even frivolous claims unjustly brought."); see also *Croskey et al., Cal. Practice Guide: Insurance Litigation* (The Rutter Group 2015), ¶ 7:522 ("The insured does not have to prove the claim against it is valid in order to obtain a defense!").

5. An "Exclusion" Precludes a Duty to Defend Argument

Insurers will sometimes rely upon an unproven and disputed allegation made in an underlying complaint to invoke a policy exclusion. California law, however, imposes a very high burden on insurers that seek to evade a defense obligation based upon a policy exclusion. This heavy burden was described by Justice H. Walter Croskey in *Atlantic Mutual Ins. Co. v. J. Lamb, Inc.*, 100 Cal.App.4th 1017, 1039 (2002), as follows:

"[A]n insurer that wishes to rely on an exclusion has the burden of proving, through conclusive evidence, that the exclusion applies in all possible worlds."

Therefore, at the duty to defend stage, an insurer may not rely upon unproven allegations to establish an exclusion's application. If there exists any "potential" that the exclusion ultimately may not apply to a judgment in the underlying action, a duty to defend is owed. See *Gray, supra*, 65 Cal.2d at 277 (intentional act exclusion did not negate defense against allegations of assault because the insured might prove at trial he engaged only in non-intentional tortious conduct).

Two federal district courts in California recently applied a number of the rules discussed in this article. See *KM Strategic Management, LLC v. American Cas. Co. of Reading, PA*, 2015 U.S. Dist. LEXIS 171435 (C.D. Cal. Dec. 21, 2015), and *MedeAnalytics, Inc. v. Federal Ins. Co.,* 2016 U.S. Dist. LEXIS 21377 (N.D. Cal. Feb. 19, 2016). In both cases, the district courts held that the CGL-insurer defendants breached a duty to defend underlying third-party lawsuits that included allegations of defamation, despite the fact that no cause of action for libel or slander had been pled. The courts also found that the insurers wrongfully relied upon an exclusion in their policies for claims arising from a "breach of contract." The courts held that to invoke this exclusion, the insurers required conclusive evidence that their insureds had *actually* — not just *allegedly* — breached a contract. Because neither of the insurers had such evidence, they were found liable for breaching the duty to defend.

As reflected in these recent decisions, the potential-for-coverage standard laid down in *Gray v. Zurich, supra,* remains as valid today as it did 50 years ago.

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