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Calif. Does Not Bar Defense Coverage For 'Willful Acts'

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Law360, New York (June 23, 2017, 10:55 AM EDT) -- California prohibits insurers from indemnifying policyholders for their intentional misconduct, as a matter of public policy and as codified in California Insurance Code section 533. This bar on insurance coverage, however, does not necessarily bar insurers from providing or paying for a defense against accusations of wrongful conduct. When California policyholders tender a complaint alleging intentional wrongdoing — such as a qui tam lawsuit alleging False Claims Act (FCA) violations — they should not simply accept an insurer's broad coverage denial relying upon Section 533.

There are two ways in which defense coverage may be available for alleged intentional misconduct, notwithstanding Section 533: (1) if there is a potential for coverage for the allegations, and (2) if the insurance policy provides an objectively reasonable expectation of coverage for the allegations. The "potential for coverage" path will be familiar to many readers — a defense obligation can be established when a lawsuit includes, or could include, another claim, such as negligence, which does not trigger Section 533.[1] This article focuses on the less familiar "reasonable expectation of coverage" path, and discusses it in the context of FCA allegations. At least one court has recognized such an expectation for defense of FCA allegations, holding that Section 533 does not prohibit an insurer from advancing defense costs.

California Insurance Code Section 533

Courts have recognized that the purpose of Section 533 is to prevent the moral hazard of encouraging intentionally harmful conduct by forbidding insurers from covering such risks.[2] California courts treat Section 533 as an implied exclusionary clause to be read into all insurance contracts, with the effect of barring insurers from providing indemnity coverage for loss caused by willful wrongdoing.

However, Section 533 does not apply to defense coverage. California courts have consistently recognized, since the California Supreme Court's seminal decision Gray v. Zurich Insurance Company,

that there is no public policy against providing a defense against alleged willful misconduct.[3] A promise to provide a defense against accusations of intentional torts does not itself encourage commission of intentional torts and thus does not create a moral hazard.

Reasonable Expectation of Defense Coverage for Alleged Intentional Conduct

Regardless of whether there is any potential for indemnification coverage for allegations of willful misconduct, an insurer is obligated to provide a defense against such allegations if the policy provides an objectively reasonable expectation of coverage for the claim. Essentially, the "reasonable expectation" test seeks to determine whether an insurer has effectively agreed to defend its policyholder against what may be a nonindemnifiable claim.

Some courts have found a reasonable expectation of coverage where the policy contains a specific promise to defend that is separate from the policy's general liability provisions. For example, in Downey Venture v. LMI Insurance Company, the California Court of Appeal found that the policy explicitly promised a defense against claims of malicious prosecution, a tort for which Section 533 precludes indemnity coverage because it has an element of malice.[4] Similarly, in Marie Y. v. General Star Indemnity Company, the policy's willful misconduct exclusion contained an exception that expressly carved back a promise to defend against lawsuits alleging such violations.[5] Other courts have also found a reasonable expectation of coverage in a policy that did not disclaim coverage for punitive damages[6] and in a policy that was ambiguous as to whether fraud was excluded.[7] And another court concluded that a directors and officers insurer failed to establish on summary judgment that its individual insured's expectation of advancement of defense costs against alleged intentional breach of contract and fraud was not reasonable.[8]

On the other hand, some decisions have gone against policyholders. The California Court of Appeal in Mez Industries v. Pacific National Insurance Company found no reasonable expectation of defense coverage for a lawsuit alleging inducement of patent infringement under federal law.[9] The court determined that Section 533 barred indemnity coverage for the inducement claim because a finding of liability would require finding specific intent to induce infringement. The court concluded that there was no reasonable expectation of defense against the claim because the policyholder could not identify any specific promise to defend such conduct. In another case, a court found that a clause in the defense provision of an employer's liability policy that provided that the insurer "may defend" against claims alleging willful misconduct did not establish a reasonable expectation of defense coverage for a wrongful termination claim because the provision merely identified an option rather than creating a duty.[10]

Application: Defense Coverage for False Claims Act Lawsuits

Policyholders seeking defense coverage in California for lawsuits or investigations alleging violations of the federal False Claims Act ("FCA"), 31 U.S.C. section 3729, or its state counterparts, such as California Government Code section 12651, likely will face arguments from their insurers that Section 533 bars coverage as a matter of public policy. In response, policyholders may be able to establish defense

coverage under both paths discussed above: (1) that there is a potential for coverage of the FCA claims and (2) that there is a reasonable expectation of defense coverage for the FCA claims.

First, there may be a potential for coverage, both for defense and indemnification, if the allegations could support a finding of liability under the FCA for merely recklessness rather than for intentional conduct. It is well established that recklessness does not implicate Section 533.[11] Liability for most types of FCA violations can be satisfied by a finding of recklessness — specifically, by acting "in reckless disregard of the truth or falsity of the information" — and without any specific intent to defraud.[12]

We have not identified any decision addressing whether Section 533 bars insurance coverage for alleged FCA violations. However, a federal district court recently determined that liability under an outdated version of the California False Claims Act ("CFCA") per se involves a "wilful act" under Section 533 — and thus there is no potential for coverage of such a CFCA claim — because that version of the CFCA included a second scienter requirement: the specific intent to induce the payment of claims.[13] It is not clear whether this court's ruling, which currently is on appeal, would apply to the current version of the CFCA or to the FCA.

Regardless of whether an FCA claim is indemnifiable, a policyholder may nevertheless have a reasonable expectation of defense coverage for an FCA claim depending upon the nature of the allegations and the specific language of the policy. For example, while some policies include exclusions for FCA allegations, others do not — and the absence of an express exclusion may support a policyholder's reasonable expectation for coverage. A policy may also provide a broad promise to defend against any and all allegations of wrongful acts. Or it may provide coverage for fraud claims or claims by or on behalf of government entities. Even where a policy has a wrongful acts exclusion, that exclusion may include a defense carve-back exception, and likely also requires that any wrongful act is finally established by adjudication for the exclusion to apply.

Although we are not aware of any California state court decision on this issue, two federal district courts recently addressed the question and reached opposite results based on differences in the policies' respective language.

A court in the Northern District of California determined that a policyholder had a reasonable expectation under its D&O policy for the advancement of defense costs for litigation involving FCA and CFCA claims.[14] The court explained that the policy's promise to advance defense costs prior to the disposition of claims was separate and distinct from the policy's general indemnity promise, and thus created a reasonable expectation of defense coverage. The court recognized that the promise to advance defense costs dovetailed with the insurer's express right under the policy to seek repayment of advanced costs upon a final determination of indemnity coverage and with the final adjudication clause of the policy's wrongful acts exclusion.

On the other hand, as discussed above, another federal district court ruled that Section 533 bars indemnity for claims made under a since-amended version of the CFCA. The court later held that there was no reasonable expectation under the relevant policy that a CFCA claim would trigger the insurer's

duty to defend.[15] The court noted that, as in Mez Industries, the policyholder failed to identify a specific promise in the policy to defend CFCA claims.

Conclusion

Before accepting an insurer's total denial of coverage for claims alleging intentional misconduct — such as submitting false claims in violation of the FCA — an insured should carefully review its applicable policies to see if, at a minimum, policy language creates a reasonable expectation for defense coverage, even if Section 533 bars indemnity coverage for the claim. Despite California's public policy against insuring loss resulting from willful acts, policyholders should not shy from insisting that their insurers honor their defense obligations.

Correction: A previous version of this article incorrectly stated one author's job title in his bio. This error has been corrected.

DISCLOSURE: The authors Darren S. Teshima and Harry J. Moren served as counsel of record for the plaintiffs in the cited case Braden Partners LP v. Twin City Fire Insurance Co. (N.D. Cal.).

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[1] E.g., Horace Mann Insurance Co. v. Barbara B, 4 Cal. 4th 1076 (1993). Horace Mann exemplifies a common situation in which, an alleged tort that can be proven by either a finding of intent or a finding of negligence, there is a potential for coverage and thus defense obligation unless and until it is established that there is no longer any possibility of liability based upon negligence.

[2] The full text of Section 533 reads: "An insurer is not liable for a loss caused by the wilful act of the insured; but he is not exonerated by the negligence of the insured, or of the insured's agents or others."

[3] Gray v. Zurich Insurance Co., 65 Cal. 2d 263, 277-78 (1966); see also Horace Mann, 4 Cal. 4th at 1087 (1993) ("no public policy forbids the defense of claims alleging intentional acts").

[4] Downey Venture v. LMI Insurance Co., 66 Cal. App. 4th 478, 509 (1998); see also Butcher v. Truck Ins. Exch., 77 Cal. App. 4th 1442, 1447, 1467 (2000) (also allowing defense coverage for a malicious prosecution lawsuit).

[5] Marie Y. v. Gen. Star Indem. Co., 110 Cal. App. 4th 928, 956, 959-60 (2003).

[6] Ohio Cas. Insurance Co. v. Hubbard, 162 Cal. App. 3d 939, 947-48 (1984).

[7] St. Paul Fire & Marine Insurance Co. v. Weiner, 606 F.2d 864, 867-68 (9th Cir. 1979).

[8] Daily v. Fed. Insurance Co., No. C04-3791 PJH, 2005 WL 1108978 (N. D. Cal. Apr. 5, 2005).

[9] Mez Indus.,Inc. v. Pac. Nat'l Insurance Co., 76 Cal. App. 4th 856, 878 (1999).

[10] B&E Convalescent Ctr., 8 Cal. App. 4th at 87, 101-02.

[11] J.C. Penney Cas. Insurance Co. v. M.K., 52 Cal. 3d 1009, 1021 (1991).

[12] 31 U.S.C. § 3729(b)(1).

[13] Office Depot Inc. v. AIG Specialty Insurance Co., No. 2:15-cv-02416-SVW-JPR, 2016 WL 6871283, at *6 (C.D. Cal. July 21, 2016).

[14] Braden Partners LP v. Twin City Fire Insurance Co., No. 14-cv-01689-JST, 2017 WL 63019, at *6 (N.D. Cal. Dec. 20, 2016).

[15] Office Depot Inc. v. AIG Specialty Insurance Co., No. CV 15-02416-SVW-LPRx, 2017 U.S. Dist. LEXIS 32389, at *11-12 (C.D. Cal. Jan. 4, 2017).