

California Appellate Court: Insurer Must Defend Insured In Alternative Dispute Resolution

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In an important decision, a California appellate court recently held in *Clarendon American Insurance Co. v. StarNet Insurance Co. (StarNet)*¹ that an insurer was required to defend its insured in a statutorily required pre-litigation dispute resolution process. This coverage issue—the question of what kind of proceeding constitutes a “suit” under a comprehensive general liability insurance policy (CGL)—is an issue of great importance to many insureds and continues a debate that has taken place in the courts throughout the country.

Background

Companies are frequently faced with the difficult question of whether to attempt to resolve a claim through alternative dispute resolution, or ADR—such as mediation or arbitration—before resorting to litigation. Important to their decision is whether their CGL policies cover the ADR process. Some CGL policies explicitly cover arbitrations and similar procedures and some have language extending coverage to “claims or suits.” However, many CGL policies have language restricting coverage to “suits.” The meaning of the term “suit” contained in these policies has been found by the courts to be capable of various constructions. As a result, courts are divided on the issue of whether a proceeding that is not filed in a court of law—whether ADR or a governmental administrative action—is a “suit” entitling an insured to the defense and indemnity protections of a CGL policy.² Litigation often involves clarifying the meaning of this policy language, and whether a particular type of proceeding is sufficiently adversarial to constitute a “suit” within the meaning of the policy language and the law.

Approximately a dozen years ago, the California Supreme Court held in an environmental coverage case that in CGL policies providing coverage only for “suits,” an insurer is only required to defend its insured

¹ 2010 WL 2904995 (Cal. App. 4th, July 27, 2010).

² Compare, e.g., *A.Y. McDonald Indus., Inc. v. Insurance Co. of N. Am.*, 475 N.W.2d 607, 618 (Iowa 1991) (EPA proceeding under RCRA is a covered “suit”) (applying Iowa law), with *Continental Insurance Companies v. Northeastern Pharmaceutical & Chemical Company (NEPACCO)*, 842 F.2d 977 (8th Cir. 1988) (en banc) (EPA proceeding under CERCLA not a “suit”) (applying Missouri law).

against “a court proceeding initiated by the filing of a complaint.”³ A later decision extended this rule to settlement, or indemnity, costs.⁴

These decisions have remained controversial and have been subjected to judicial criticism.⁵ More recently, a California appellate court noted in *Ameron*, a 2007 insurance coverage decision, that, had it been “writing on a blank slate,” it would have held that a “knowledgeable government contractor” would “reasonably expect” that an administrative hearing on a government contract issue is a “suit seeking damages” under a standard CGL policy against which its insurers were required to defend.⁶ The court noted, however, that it was required to follow the California Supreme Court’s precedent to the contrary and rule in favor of the CGL insurers. The California Supreme Court has granted review of the *Ameron* decision and will hear the case on September 7, 2010. The issue in question: “Does a proceeding before the United States Department of the Interior Board of Contract Appeals constitute a ‘suit’ such as to trigger insurance coverage under a CGL policy?”

The *StarNet* Decision

Debate on this issue—what constitutes, or does not constitute, a “suit” under a CGL policy—continues to percolate in the lower courts as well, as shown in *StarNet*. There, a homeowner’s association served notice on a developer that it was “commencing proceedings” to recover damages for construction defects. Common interest development associations in California must give notice to a builder, developer, or general contractor of construction or design defects and then engage in an extended dispute resolution process before filing suit. Commonly called the “Calderon Process,” this process is intended to encourage settlement and discourage litigation.

One insurer denied that it was required to defend the policyholder against the Calderon Process as its policies provided: “We will have the right and duty to defend the insured against any ‘suit’ seeking . . . damages” because of “property damage.” The insurer asserted that the Calderon Process was not a “suit” because it could not “result in a party being legally obligated to pay damages.” Another insurer asserted, however, that the Calderon Process was a “suit” to which a defense was owed because the first insurer’s policy defined the word “suit” to include “a civil proceeding in which damages because of . . . ‘property damage’ to which this insurance applies are alleged.”

The appellate court held that the Calderon Process was indeed a “suit,” even though it did not involve “a court proceeding initiated by the filing of a complaint.” After noting, essentially, that it *was* writing on a “blank slate,” the court held that “[d]efined as ‘a civil proceeding,’ a suit is broader than an action or lawsuit initiated by a complaint filed in court.” It then examined the effect of the defense agreement in the policies “in full context.” It noted that the Calderon Process involved certain hallmarks of civil litigation, such as the exchange of documents, visual inspections of the allegedly defective properties, the creation of a document depository, and the service of a demand in “sufficient detail for the parties to engage in meaningful dispute resolution.”⁷

³ *Foster Gardner, Inc. v. National Union Fire Ins. Co.*, 18 Cal. 4th 857, 887 (1998).

⁴ *Powerine Oil Co., Inc. v. Superior Court*, 37 Cal. 4th 377 (2005).

⁵ Three sitting California Supreme Court Justices are on record stating that these decisions are flawed and should be reversed. See *County of San Diego v. ACE Prop. & Cas. Ins. Co.*, 37 Cal. 4th 406, 426–27 (2005) (Wedergar, J.; Moreno, J.; Kinnard, J., concurring separately).

⁶ *Ameron Int’l Corp. v. Insurance Co. of State of Pennsylvania*, 60 Cal. Rptr. 3d 55 (Cal. Ct. App. 2007), review granted, 65 Cal. Rptr. 3d 142 (2007).

⁷ *Id.*

The Calderon Process also implicated allegations of “damages,” according to the court, because it was just “one part—the first step—in a continuous litigation process.” The process was “mandatory.” It required the service of a demand for “damages.” Its results were “incorporated into and become part of the postcomplaint litigation.” Settlements reached during the process are binding on parties that failed to attend or lacked authority to settle at the proceedings they attended. The *StarNet* court concluded that “[t]he Calderon Process is more than a prelitigation alternative dispute resolution requirement: It is part and parcel of construction or design defect litigation initiated by an association and, as such, cannot be divorced from a subsequent complaint.” Thus, the “reasonable inference” was that the parties to the insurance contract “would have a duty to defend the insured in the Calderon Process. Extending the duty to defend to the Calderon Process is therefore consistent with a hypothetical insured’s reasonable expectations.”⁸

Impact on Corporations

StarNet strikes a familiar chord in insurance coverage litigation, emphasizing once again that words and phrases used in an insurance policy do not have abstract meanings divorced from the “full context” in which they are found. Consideration of the “full context” might lead counterintuitively to the “reasonable inference” that an insurer’s agreement to defend a “suit” does not necessarily require “a court proceeding initiated by the filing of a complaint,” nor is coverage of “damages” limited to “money ordered by a court.” These terms can be construed to mean something quite different in light of *all* of the circumstances in which the policyholder finds itself when seeking the financial assistance of its insurer to defend against a “suit.”

A policyholder facing a “claim,” an administrative proceeding, or mandatory ADR thus should undertake a rigorous policy analysis to determine the operative contract language and to examine all potentially applicable law, since the choice of law or forum can determine the outcome of the case, particularly on an issue such as this where the jurisdictions and courts are so sharply split. What may be an “uncovered” claim in one jurisdiction could be a “covered” suit in another.

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⁸ *Id.*

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