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Several recent California decisions have significantly improved the ability of companies to persuade their insurers to provide insurance coverage for business-related liability claims. This article discusses three recent cases in which California courts imposed broad obligations on insurers to cover contract disputes, intellectual property claims and employment termination torts.

Coverage for Breach of Contract Claims

For many years, insurance companies argued there was a general rule in California that a dispute arising out of a breach of contract could not be covered by liability insurance policies. They routinely refused to provide coverage for such cases, asserting that liability arising out of a contract breach was not fortuitous but, rather, the result of a negotiated transaction. They might cite the example of a tenant's breach of his agreement to pay rent and point out how unfair it would be for an insurer to have to pay the rent obligation for the tenant.

What insurers failed to consider was that some liability arising out of a breach of contract was expressly covered by their policies. For example, if a tenant accidentally caused damage to the landlord's property, the landlord could sue him for breach of his contractual obligation to keep the premises in good repair. In the past, many insurers rejected coverage for such claims even though the renter's policies covered liability for property damage caused by an accident.

However, if the landlord chose to sue the renter on a different legal theory, asserting a claim for negligence rather than breach of contract, the insurers would cover the claim. This produced the anomalous result that insurers would often decide whether or not to cover a claim based on the legal theory in the complaint (the "pleading") filed by the attorney suing the policy holder, rather than on the nature of the injury suffered by the claimant.

This analysis, and the "general rule" upon which it was based was clearly inconsistent with a 35-year-old landmark decision of the California Supreme Court, Gray v. Zurich (1966) 65 Cal.2d 263. In Gray, the Supreme Court rejected the idea that an attorney's choice of legal theories in a pleading should decide the outcome of insurance coverage issues.

While the ruling in Gray was seemingly straightforward enough, a number of insurance companies convinced several California appellate courts to believe there was no coverage for contract claims because of the supposed "general rule." They also cited language in the policies that, they claimed, excluded liability arising out of contract.

Finally, the issue reached the California Supreme Court when it was asked to decide whether a landlord's claim for breach of contract against its tenant was covered. In Vandenberg vs. Superior Court (1999) 21 Cal.4th 815, the court ruled that a tenant who had accidentally contaminated the landlord's property with pollutants was covered by his insurance policy, even though the only claim asserted against him was for breach of contract.

Echoing the Gray decision, the Court said: "Predicating coverage upon an injured party's choice of remedy or the form of action sought is not the law of this state."

The court summarily rejected the insurers' claim that certain language in the policy excluded liability arising out of contracts. The court noted that the language at issue, which limited coverage to

damages the policy holder "was legally obligated to pay" did not rule out coverage for contract claims. Rather, when the language was given its "ordinary and popular meaning," it seemed to suggest just the opposite, i.e., that insurers should cover contract claims as well as tort claims: "A reasonable layperson would certainly understand legally obligated to pay to refer to any obligation which is binding and enforceable under the law, whether pursuant to contract or tort liability".

The importance of the Vandenberg decision is difficult to overstate. In addition to unanimously disapproving seven California appellate court decisions that had ruled there was no coverage for contract claims, it strongly reaffirmed, in the context of a business dispute, the broad application of fundamental principles of insurance coverage law announced 35 years earlier in the Gray case. Most importantly, it opened up the possibility of insurance coverage for virtually any business dispute involving covered claims arising out of a contractual relationship.

2. Coverage for Intellectual Property Claims

In the wake of the recent explosion of intellectual property litigation, a decision by California's Second District Court of Appeal provides welcome news for beleaguered companies who have been the targets of such lawsuits. In Lebas Fashion Imports vs. ITT Hartford Ins. Group (1996) 50 Cal.App.4th 548, the Court held that Hartford was obligated to pay for the costs of defending Lebas in a trademark infringement case.

Lebas was an importer and wholesaler of men's clothing in Los Angeles. It purchased a standard form CGL policy from Hartford that contained coverage for "misappropriation of advertising idea or style of doing business." Lebas was sued for trademark infringement and asked Hartford to defend it under the terms of the insurance policy. When Hartford refused to pay its legal bills, Lebas sued. The Court of appeal found that the phrase "misappropriation of advertising idea or style of doing business" was ambiguous and concluded, therefore, that Hartford should have defended the lawsuit against Lebas. The Court interpreted the term "misappropriation" broadly to mean "to take wrongfully," rather than in the narrow technical sense advocated by Hartford.

The Lebas decision is important for a number of reasons. First, and most obviously, it stands for the proposition that insurers must defend trademark infringement cases under many standard form CGL policies. Second, in broadly construing the term "misappropriation," and finding the insuring clause ambiguous, the Court opened the door for the argument that other types of intellectual property torts, such as unfair competition, trade dress infringement and even patent infringement claims, may be covered under these insurance policies.

3. Coverage for Employment Termination Torts

Another type of claim that has become all too common in recent years are those arising out of employment termination. While insurers have started to offer special Employment Practices Liability (EPL) policies to their business customers, many policy holders have balked at the added expense and, thus, have only the standard form CGL coverage. Unfortunately, many of these policies have "employment related acts" exclusions.

However, a fundamental principle of California law requires that courts interpret exclusions in insurance policies narrowly. In HS Services Inc. vs. Nationwide Mut. Ins. Co. (9th Cir. 1997) 109 F.3d 642, the Ninth Circuit Court of Appeal considered the application of an exclusion for "employment related acts" to a claim that an employer had defamed its employee after termination of his employment. The alleged defamatory statements were made to customers after the employee started a competing business.

The Ninth Circuit reasoned that post-termination employer torts are "employment related" only if the tort's relationship to the employment is direct and proximate. The Court concluded that the alleged defamatory statements were made in response to accusations by the competing ex-employee, and thus related to competition in the marketplace, rather than to the former employment.

Conclusion

Given the mounting expense of defending business-related torts, companies should carefully consider notifying their insurers of such claims. Since late notice may be a defense to coverage, notice should be given as soon as possible.

As the Vandenberg, Lebas and HS Services cases make clear, California insurance law can change in unexpected ways with each decision of the courts. Thus, if there is any doubt about coverage for a particular claim, companies are well advised to consult with an insurance specialist to determine whether coverage is available.

BIOGRAPHY

Paul Hilding is a graduate of Duke Law School (J.D. 1983). He was the founder and chairman of the Insurance Coverage/Bad Faith Section of the San Diego County Bar Association from 1990-1998. Formerly a partner with the firm of Brobeck, Phleger & Harrison, he has been a partner with Hilding Kipnis Lyon & Kelly since 1993. He specializes in insurance coverage and business litigation.