HOT TOPICS IN INSURANCE COVERAGE AND BAD FAITH LITIGATION IN CALIFORNIA

Lorman Education Services

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THE WAR OVER "REASONABLE EXPECTATIONS" NEW WEAPONS FOR POLICY HOLDERS

A. A Long and Honored Tradition: 100 Years of Not Reading Insurance Policies

1. The First Bleeding Heart Liberals: The California Supreme Court of 1910

Raulet: Fire Insurance Claim denied because of exclusion for encumbrance on property

"It must be presumed, ordinarily, that persons are familiar with the terms of written contracts to which they are parties, and in the absence of fraud they are justly bound by the provisions therein, but the rule should not be strictly applied to insurance policies. It is a matter almost of common knowledge that a very small percentage of policy-holders are actually cognizant of the provisions of their policies and many of them are ignorant of the names of the companies issuing the said policies. The policies are prepared by the experts of the companies, they are highly technical in their phraseology, they are complicated and voluminous -- the one before us covering **thirteen pages** of the transcript – and in their numerous conditions and stipulations furnishing what sometimes may be veritable traps for the unwary. The insured usually confides implicitly in the agent securing the insurance, and it is only just and equitable that the company should be required to call specifically to the attention of the policy-holder such provisions as the one before us."

"The courts, while zealous to uphold legal contracts, should not sacrifice the spirit to the letter nor should they be slow to aid the confiding and innocent."

Raulet v. Northwestern National Ins. Co. (1910) 157 Cal. 213, 230.

2. An Historic Echo: The 2004 California Supreme Court

Haynes: **Insurer limited coverage for permissive user to statutory minimum based on endorsement**

For nearly a hundred years we have recognized that " 'the rule [presuming parties are familiar with contract terms] should not be strictly applied to insurance policies. It is a matter almost of common knowledge that a very small percentage of policy-holders are actually cognizant of the provisions of their policies ... . The insured usually confides implicitly in the agent securing the insurance, and it is only just and equitable that the company should be required to call specifically to the attention of the policy-holder such provisions as the one before us.' " (*Raulet v. Northwestern etc. Ins. Co.* (1910) 157 Cal. 213, 230 [107 P. 292] [discussing a lien provision].) Thus, an insurer's direction to the subscriber to read the entire policy, "is not a substitute for notice to the subscriber of a loss of benefit."

Haynes v. Farmers Ins. Exchange (2004) 32 Cal.4th 1198

B. <u>The California Supreme Court Finds a Scholarly Rationale to Protect the Unwary: Adhesion Contracts in the Age of the Machine</u>

Steven: **Insured purchased life insurance policy from vending machine at airport with exclusion for unscheduled flights.**

The approach of the California courts to the exculpatory or exclusionary clause of the standardized contract finds a reflection in cases of other states and in the writings of the commentators. Indeed, some legal authorities categorize the instant contract and comparable agreements under the term "contract of adhesion" to give it a more definite place in the law and to emphasize the need for the strict judicial scrutiny of its terms. The term refers to a standardized contract prepared entirely by one party to the transaction for the acceptance of the other; such a contract, due to the disparity in bargaining power between the draftsman and the second party, must be accepted or rejected by the second party on a "take it or leave it" basis, without opportunity for bargaining and under such conditions that the "adherer" cannot obtain the desired product or service save by acquiescing in the form agreement.

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This term was first used in **French** legal analysis in 1901. (Salleilles, De la Declaration de Volonte 229.) It was introduced into Anglo-American Jurisprudence by Edwin W. Patterson in 1919 (Patterson, *The Delivery of a Life-Insurance Policy*, 33 Harv.L.Rev. 198, 222), and since has become common in legal writing. It is gradually finding its way into judicial opinions. (See *Siegelman* v. *Cunard White Star, Ltd.* (2d Cir. 1955) 221 F.2d 189, 204 (Frank, J., dissenting)

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As Professor Kessler states, "Standard contracts are typically used by enterprises with strong bargaining power. The weaker party, in need of the goods or services, is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly (natural or artificial) or because all competitors use the same clauses. His contractual intention is but a subjection more or less voluntary to terms dictated by the stronger party, terms whose consequences are often understood only in a vague way, if at all." Kessler, *Contracts of Adhesion -- Some Thoughts about Freedom of Contract*, 43 Colum. L. Rev. 629, 632 (1943).

. . .

To equate the bargaining table, where each clause is the subject of debate, to an automatic vending machine, which issues a policy before it can even be read, is to ignore basic distinctions. The proposition that the precedents must be viewed in the light of the imperatives of the age of the machine has become almost axiomatic. Here the age of the machine is no mere abstraction; it presents itself in the shape of an instrument for the mass distribution of standard contracts. The exclusionary clause of that contract, upon which the insurance company relies, is an unexpected one. Its application in some circumstances would be unconscionable. It is placed in an inconspicuous position in the document. In view of all these characteristics its rigid application would cast an unexpected burden upon the traveling public and would prefer formality of phrase to the reality of the transaction.

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TRAYNOR, J., Dissenting. In my opinion the policy covered travel by air only on scheduled air carriers. I find no basis for assuming that the ordinary traveler would reasonably believe that the policy covered travel on other than scheduled air carriers, and since there is no rule of law that requires defendant to cover risks it does not wish to cover, I would affirm the judgment.

Steven v. The Fidelity & Casualty Co. of New York (1962) 58 Cal.2d 862. Opinion by Tobriner

C. More Left-Wing Heresy: The Reasonable Expectations Doctrine

Gray: **Insurer declined to defend lawsuit alleging assault**

These principles of interpretation of insurance contracts have found new and vivid restatement in the doctrine of the adhesion contract.

. . .

Although courts have long followed the basic precept that they would look to the words of the contract to find the meaning which the parties expected from them, they have also applied the doctrine of the adhesion contract to insurance policies, holding that in view of the disparate bargaining status of the parties n6 we must ascertain that meaning of the contract which the insured would reasonably expect.

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Isaacs, *The Standardizing of Contracts* (1917) 27 Yale L.J. 34, in an early analysis, suggests the basis for the adhesion contract, pointing out that standardized contracts create "status" relationships as opposed to individualized relationships. The article states: "The movement toward status law clashes, of course, with the ideal of individual freedom in the negative sense of 'absence of restraint' or *laissez faire*. Yet, freedom in the positive sense of presence of opportunity is being served by social interference with contract. . . Pound, The Spirit of Common Law (1921) states: "Taking no account of legislative [i.e., non-common law] limitations upon freedom of contract, in the purely judicial development of our law we have taken the law of insurance practically out of the category of contract, and we have established that the duties of public service companies are not contractual, as the nineteenth century sought to make them, but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and his consequent relation to the public."

Gray v. Zurich ins. Co. (1966) 65 Cal.2d 263. Opinion by Tobriner, Traynor concurred.

D. Two Insurance Companies Squabble over Whether "Conspicuous Plain & Clear" Requirements Applies even when Insured does not Reasonably Expect Coverage: Policy Holders Win

Liberty does not contest the district court's finding that the liability limiting clause was not in fact conspicuous as a matter of law. It argues, however, that we need reach the issue of whether the clause was conspicuous only if the clause was contrary to the reasonable expectations of the insured. 20th Century disagrees, contending that the requirement that an exclusionary clause be "conspicuous, plain and clear" operates independently of the expectations of the insured.

While not an entirely settled issue under California law, the significant weight of California authority holds that an exclusionary clause in an insurance policy must be conspicuous, plain, and clear in order to be effective against the insured, *regardless* of the expectations of the insured.

20th Century Ins. Co v. Liberty Mutual Ins. Co. (9th Cir. 1992) 965 F.2d 747.

E. *Haynes v. Farmers:* The California Supreme Court finds that Coverage Limitations Contained in an Endorsement are not Conspicuous, Plain and Clear

Haynes: **Insurer tried to fix prior problem with form by adding endorsement limiting coverage for permissive users**

1. Supreme Court Criteria for Conspicuous:

1. Nothing on the declarations page alerts a reader to the fact that the endorsement . . . contains a paragraph limiting coverage for permissive users;

2. The declarations page does not reveal the substance of any of the endorsements, nor does it say the endorsements amend the policy or form a part of it;

3. Policy holder does not learn of limitation until he/she turns to the 24th page

4. The language of the permissive user limitation is not bolded, italicized, enlarged, underlined, in different font . . . or in any other way distinguished from the rest of the fine print.

5. Title of endorsement ["LIABILITY – PERMISSIVE USER – LIMITATION] "does not state that the limitation concerns liability coverage amounts."

Endorsements are not conspicuous per se.

Warning to read the policy carefully is no substitute for requirement of conspicuous placement.

2. Plain and Clear Issue

Conspicuous placement of exclusionary language is only one of two rigid drafting rules required of insurers to exclude or limit coverage. The language itself must be plain and clear. This means more than the traditional requirement that contract terms be "unambiguous." Precision is not enough. Understandability is also required.

Criteria for plain and clear:

1. "Permissive user" is not defined. While attorneys and insurance professionals might understand meaning, "the average lay reader encountering the term . . . would not necessarily understand its significance."

2. Confusing cross references to other parts of policy.

3. Direction to insert the language into two portions of the policy is confusing.

Especially as "an exclusion is subjected to the closest possible scrutiny" (*Ponder v. Blue Cross of Southern California*, *supra*, 145 Cal. App. 3d at p. 718) and judged from the perspective of an average layperson (*Thompson*, *supra*, 84 Cal.App.4th at p. 97), we conclude that Farmers has not met its burden to phrase exceptions and exclusions in " 'clear and unmistakable language' " (*State Farm Mut. Auto. Ins. Co. v. Jacober*, *supra*, 10 Cal.3d at p. 202).

Note: Farmers also argued that even if endorsement was not conspicuous, plain and clear, it did not defeat reasonable expectations of insured, and therefore should be enforced. Court concluded it did defeat reasonable expectations, without ever addressing issue of whether this second inquiry was necessary (See *20th Century, infra).*

Haynes v. Farmers Ins. Exch. (2004) 32 Cal.4th 1198.

F. <u>The Ambiguity Doctrine and More Variations on Reasonable Expectations</u>

1. No fair analyzing reasonable expectations <u>after</u> your son shoots his best friend

Robert S: **Teenage son of insured shoots friend "by accident."**

When a homeowners policy expressly covers accidental bodily injury but excludes coverage for bodily injury arising out of an "illegal act," is the insurer obligated to defend and indemnify its insureds in a wrongful death action brought

against them after their teenage son *accidentally* shot and killed his friend? We conclude that, in the context of the policy as a whole, the insurer does have such an obligation.

The homeowners policy here excluded coverage "arising out of any *illegal* act committed by or at the direction of an insured." (Italics added.) The phrase "illegal act" is susceptible of two reasonable meanings. As mentioned earlier, the Court of Appeal, relying on a dictionary definition, construed the term broadly, as meaning any act prohibited by law. But the term can also be interpreted more narrowly as meaning a violation of criminal law. This is the construction Safeco urges us to adopt. Certain thesauruses do treat the term "illegal" as synonymous with "criminal." (See, e.g., Burton, Legal Thesaurus (1980) p. 257 [stating that "against the law" and "criminal" are synonyms of "illegal"]; Webster's Collegiate Thesaurus (1976) p. 414 [stating that "criminal" is a synonym of "illegal"].) If we were to adopt this meaning in the context of the policy here, we would have to treat the policy's clause excluding coverage for an "illegal act" as the equivalent of a clause excluding coverage for a "criminal act."

The policy before us, however, contains not a *criminal act* exclusion but an *illegal act* exclusion. Had Safeco wanted to exclude criminal acts from coverage, it could have easily done so. Insurers commonly insert an exclusion for criminal acts in their liability policies. (Croskey & Kaufman, Cal. Practice Guide: Insurance Litigation (The Rutter Group 2000) PP 7:331.5, 7:2256, pp. 7A-86, 7I-23 (rev. # 1, 2000).) Because Safeco chose not to have a criminal act exclusion, instead opting for an illegal act exclusion, we cannot read into the policy what Safeco has omitted. To do so would violate the fundamental principle that in interpreting contracts, including insurance contracts, courts are not to insert what has been omitted.

We now consider the Court of Appeal's construction of the term "illegal" as meaning violation of *any* law, whether civil or criminal. (See, e.g., Webster's 9th New Collegiate Dict. (1989) p. 599 ["not according to or authorized by law; unlawful"]; Webster's New World Dict. (2d college ed. 1982) p. 699 ["prohibited by law; against the law; unlawful; illicit; also, not authorized or sanctioned, as by rules"]; Black's Law Dict. (5th ed. 1979) p. 673, col. 2 ["against or not authorized by law"]; see Evid. Code, § 160 [" 'Law' includes constitutional, statutory, and decisional law"].) That construction, however, is so broad as to render the policy's liability coverage practically meaningless.

For instance, a violation of "any law" would include the law governing negligence, which holds individuals responsible for the failure to exercise ordinary care resulting in injury to another. (Civ. Code, § 1714 ["Every one is responsible . . . for an injury occasioned to another by his want of ordinary care or skill . . . ."].) The duty to exercise ordinary care is imposed by law. (See *Sharon P. v. Arman, Ltd.* (1999) 21 Cal. 4th 1181, 1188-1889 [91 Cal. Rptr. 2d 35, 989 P.2d 121].) A violation of that duty is therefore *a violation of law*. Broadly

construed, a violation of *any* law, whether civil or criminal, is an illegal act. An insured's negligent act, being a violation of law and therefore *an illegal act*, would thus not be covered under Safeco's policy excluding coverage for an insured's illegal acts.

But the homeowners policy that the insureds here bought from Safeco expressly provided that Safeco would defend and indemnify them for bodily injury caused by "an occurrence," which the policy defines as "an accident . . . which results, during the policy period, in bodily injury or property damage." Because the term "accident" is more comprehensive than the term "negligence" and thus includes negligence (Black's Law Dict., *supra*, at p. 14, col. 2), Safeco's homeowners policy promised coverage for liability resulting from the insured's negligent acts. That promise would be rendered illusory if, as discussed above, we were to construe the phrase "illegal act," as contained in the policy's exclusionary clause, to mean violation of any law, whether criminal or civil. When reasonably practical, contracts are to be interpreted in a manner that makes them reasonable and capable of being carried into effect, and that is consistent with the parties' intent. (Civ. Code, § 1643; see *Palmer v. Truck Ins. Exchange* (1999) 21 Cal. 4th 1109, 1115 [90 Cal. Rptr. 2d 647, 988 P.2d 568].)

Safeco would have us give effect to the policy's illegal act exclusion in this case, despite the absence of any satisfactory definition of the word "illegal," because any insured would reasonably expect that an accidentally caused death resulting in a conviction for involuntary manslaughter would fall within the policy's "illegal act" exclusion. Safeco's view leaves the exclusionary clause without meaning until after an event has occurred. This violates the rule that expectations of the insured are examined at the time the contract is made. (Civ. Code, §§ 1636, 1649; *Montrose Chemical Corp. v. Admiral Ins. Co.*, *supra*, 10 Cal. 4th at p. 666.)

Moreover, an insured's objectively reasonable expectations are measured not by an insured's knowledge of the nuances of criminal law, but by what an insured would expect to be covered by the policy. The proper inquiry is: Would reasonable insureds expect their homeowners policy to protect them against liability for accidental injury or death occurring in their home? The answer is yes.

In short, because the illegal act exclusion cannot reasonably be given meaning under established rules of construction of a contract, it must be rejected as invalid. (Civ. Code, § 1653.)

2. A Final Example of the Virtue of Brevity

Emmi: **Policy excludes coverage for theft of jewels unless the insured was "in or upon" vehicle**

A policy provision is ambiguous when it is susceptible to two or more reasonable constructions. (*Waller, supra*, 11 Cal.4th at p. 18.) Language in an insurance policy is "interpreted as a whole, and in the circumstances of the case, and cannot be found to be ambiguous in the abstract." (*Ibid.*) "The proper question is whether the [provision or] word is ambiguous in the context of *this* policy and the circumstances of *this* case. [Citation.] '**The provision will shift between clarity and ambiguity with changes in the event at hand**.' [Citation.]" (*Bay Cities Paving & Grading, Inc. v. Lawyers' Mutual Ins. Co*. (1993) 5 Cal.4th 854, 868 [21 Cal. Rptr. 2d 691, 855 P.2d 1263].)

Furthermore, policy exclusions are strictly construed (see e.g., *Waller, supra*, 11 Cal.4th at p. 16; *MacKinnon v. Truck Ins. Exchange* (2003) 31 Cal.4th 635, 648 [3 Cal. Rptr. 3d 228, 73 P.3d 1205]), while exceptions to exclusions are broadly construed in favor of the insured (*Aydin Corp. v. First State Ins. Co.* (1998) 18 Cal.4th 1183, 1192 [77 Cal. Rptr. 2d 537, 959 P.2d 1213]; *National Union Fire Ins. Co. v. Lynette C.* (1991) 228 Cal. App. 3d 1073 [279 Cal. Rptr. 394]). " '[A]n insurer cannot escape its basic duty to insure by means of an exclusionary clause that is unclear. As we have declared time and again "any exception to the performance of the basic underlying obligation must be so stated as clearly to apprise the insured of its effect." [Citation.] Thus, "the burden rests upon the insurer to phrase exceptions and exclusions in clear and unmistakable language." [Citation.] The exclusionary clause "must be *conspicuous, plain and clear*." ' [Citation.] This rule applies with particular force when the coverage portion of the insurance policy would lead an insured to reasonably expect coverage for the claim purportedly excluded." (*MacKinnon, supra*, at p. 648.)

Justice Chin, in dissent, agrees with the Court of Appeal, and argues the words "on" and "upon," viewed from a "historical perspective" unambiguously referred to a "horse or horse-drawn carriage" when first used more than a century ago to support his conclusion that in contemporary usage those words refer only to vehicles such as motorcycles. (Dis. opn. of Chin, J., *post*, at p. 489.) This historical meaning of the words used in a policy, however, does not illuminate the meaning of the policy language to a reasonable layperson in contemporary times, who may well be unaware of this historical meaning. Even accepting that the words once unambiguously referred to horses and horse-drawn carriages, that clarity loses its luster when applied to "vehicles" in a modern insurance policy. That is, words that may once have been unambiguous, are not necessarily so when the context of their usage has changed. In interpreting policy language, we construe it as would a reasonable layperson, not an expert, attorney, or a historian. (*Crane v. State Farm & Cas. Co., supra*, 5 Cal.3d at p. 115.)

Emmi v. Zurich American Ins. Co. (2004) 32 Cal.4th 465.