FEATURED ARTICLE

Insurance Litigation

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Bad Faith

***Moradi-Shalal* does not prohibit UCL claim against insurer.**

Zhang v Superior Court (2009) 178 CA4th 1081, 100 CR3d 803

The insured filed a lawsuit alleging that the insurer violated the Unfair Competition Law (UCL) (Bus & P C §§17200–17210) by falsely advertising and fraudulently misrepresenting that it would provide coverage in the event that the insured suffered a loss. The insurer demurred on the grounds that the UCL cause of action violated the Unfair Insurance Practices Act (Ins C §§790–790.15). See Ins C §790.03. The trial court sustained the demurrer.

The Fourth District Court of Appeal reversed. Defendant argued that the supreme court in *Moradi-Shalal v Fireman's Fund Ins. Cos.* (1988) 46 C3d 287, 250 CR 116, held that an insurer is never liable in tort for its unfair practices. However, *Moradi-Shalal* was a third party action brought under Ins C §790.03, not the UCL. Further the supreme court in *Moradi-Shalal* noted that "the courts retain jurisdiction to impose damages and civil remedies against insurers in appropriate common law actions, under traditional theories such as fraud. . . ." 46 C3d at 304. Here, the insured alleged conduct that violates the UCL, and there is no reason to interpret *Moradi-Shalal* as prohibiting a false advertising cause of action.

COMMENT: Ever since the California Supreme Court held that there is no private right of action for unfair claims practices under Ins C §790.03(h), insurers have argued that they are completely immune from liability under any theory if that liability would also be a violation of §790.03(h). As the *Zhang* court explains, this is untrue. If the only basis for liability would be a violation of §790.03, then a plaintiff cannot bootstrap a claim under some other theory. However, if an action (such as, in this instance, fraud) would be a violation under both §790.03(h) and some other common law or statutory claim, there is no prohibition against pursuing the latter.—*Arnold R. Levinson*

COMMENT: Mr. Levinson's analysis of *Zhang* is correct as far as it goes. What it fails to note, however, is the significant difficulty cases such as *Zhang* present in helping trial courts determine when a complaint crosses the line into *Moradi-Shalal* territory. Although a bright-line rule is no doubt impossible, the demarcation between viable UCL claims and prohibited Ins C §790.03 claims is becoming increasingly blurred. Part of the problem may lie with insurers themselves. By challenging these claims at the demurrer stage, when the court must accept the allegations as true and give every benefit of the doubt to the pleading, carriers are essentially fighting with a half-empty arsenal. Although it might cost a little more to develop a factual record on which to challenge the asserted claims, it might well be that the long-term savings would justify the front-end expenditure.—*Susan M. Popik*

Duty to Defend

Stay of insurer's declaratory relief action overturned because coverage issues did not overlap issues in pending litigation against insured.

Great Am. Ins. Co. v Superior Court (2009) 178 CA4th 221, 100 CR3d 258

The insurer settled two groundwater contamination cases on behalf of the insured. When a third, related case against the insured was filed, the insurer filed a declaratory relief action for an order that policy limits were exhausted and thus it was not required to defend the insured in the remaining action. The insured argued that the declaratory relief action should be stayed because it involved issues that overlapped with issues to be decided in the lawsuit and a potential, but unfiled, counterclaim for bad faith. The trial court stayed the declaratory relief action.

The Second District Court of Appeal reversed. The only issue to be decided in the declaratory relief action is the interpretation of the policy. Thus, there are no overlapping issues that would prejudice the insured on any issue to be determined in the underlying lawsuit. Because the bad faith claim is unfiled, it is premature to rule on whether it would overlap with the declaratory relief action.

However, the existence of the declaratory relief action has prejudicial impact that the trial court did not consider: Whenever an insurer seeks an order that policy limits are exhausted while there is litigation against the insured, the necessity of defending the two actions simultaneously prejudices the insured. *Montrose Chem. Co. v Superior Court* (1994) 25 CA4th 902, 910, 31 CR2d 38. On the other hand, if the declaratory relief action is stayed, the insurer is prejudiced by expending defense costs that it may be unable to recoup. On remand, the trial court should reconsider whether to stay the declaratory relief action by balancing the competing interests of both parties.

COMMENT: An insurer has a duty to defend an insured whenever there is any possibility of coverage under the policy. Indemnity requires actual coverage. Thus, when an insured is sued, one potential avenue for an insurer is to file a companion declaratory relief action seeking an order establishing a lack of coverage. This insurer practice is sometimes viewed as suspect because it exposes an insured to two lawsuits instead of one. The general rule of thumb is that if the insured would be prejudiced by the declaratory relief action, the action must be stayed pending resolution of the underlying personal injury action. The test of prejudice is generally whether a fact could be decided in the declaratory relief action, which could adversely affect the insured in the personal injury action. Here, the court found that no such preju-

dice was presented and overturned the trial court on that ground.—*Arnold R. Levinson*

COMMENT: Reading Mr. Levinson's comments on the *Great American* case, one could only conclude that the case is thoroughly insignificant, to be brushed away as so much lint on the sleeve of California jurisprudence. Although it is true that the case does not break new ground, its critical holding that "a stay is not required if the court in the coverage action may resolve the coverage question as a matter of law without making any factual determinations that would prejudice the insured in the third party action" is one that is frequently more honored in the breach than in the observance. See *GGIS Ins. Servs., Inc. v Superior Court* (2008) 168 CA4th 1493, 1505, 86 CR3d 515. The court of appeal's cogent analysis of the issue will thus be of critical import in helping trial courts understand the limits of their discretion in staying declaratory actions pending resolution of underlying tort claims.

As the court makes clear, the key question in determining whether an action seeking a declaration of noncoverage must be stayed is "whether there are any issues to be resolved in the declaratory relief action which would overlap with issues to be resolved in the underlying action, such that proceeding on the declaratory relief action could prejudice the insureds in the trial of the underlying action," *i.e.,* whether facts developed in the coverage action might support the underlying plaintiff's claim of liability. 178 CA4th at 233. Thus, "if the declaratory relief action can be resolved without prejudice to the insured in the underlying action—by means of undisputed facts, issues of law, or factual issues unrelated to the issues in the underlying action—*the declaratory relief action need not be stayed.*" 178 CA4th at 235 (emphasis added).

Despite these settled rules, trial courts too often reflexively stay coverage actions without even attempting to determine whether there is any real overlap between the issues to be litigated in the two actions, or if there is, whether the declaratory action can be resolved without deciding issues of fact that are implicated in the tort action. The result is prejudice to the insurer, which is required to continue to defend the underlying lawsuit through to conclusion, despite the fact it may well have no duty to do so. Although a court must stay a declaratory action when a case cannot be resolved without resolving facts at issue in the underlying injury action, if that scenario does not exist, the court should not automatically stay the coverage action. Rather, "in a case in which there is no factual overlap with the issues to be resolved in the underlying case, the trial court must exercise its discretion on a motion for stay, balancing the insured's interest in not fighting a two-front war against the insurer's interest in not being required to continue paying defense costs which it may not owe and likely will not be able to recoup." 178 CA4t at 237. Thus, although not breaking new ground, the court's thorough explication of the rules governing stays in the context of insurance coverage actions must be viewed as a significant and welcome addition to California law.—*Susan M. Popik*

ERISA

ERISA does not preempt state's practice of disapproving insurance policies with "discretionary" clauses.

Standard Ins. Co. v Morrison (9th Cir 2009) 584 F3d 837

The Montana State Insurance Commissioner contends that state law requires disapproval of contracts that grant an insurer the discretion to construe and interpret the terms and provisions of its plans ("discretionary clauses"). When the insurer in this case submitted for approval its proposed disability insurance forms to the commissioner, he denied the request because the forms contained "discretionary clauses." The insurer sued, and the district court upheld the decision of the commissioner.

The Ninth Circuit Court of Appeals affirmed. The insurer contended that the commissioner's practice violates the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001–1461), which preempts state laws "insofar as they . . . relate to any [covered] employee benefit plan." 29 USC §1144(a). However, the ERISA scheme "saves" from preemption state laws regulating insurance, banking, and securities. 29 USC §1144(b). Here, the commissioner's practice qualifies as a state regulation of insurance that is saved from preemption by §1144(b) because it is (1) specifically directed at insurance companies and (2) substantially affects risk pooling arrangements by increasing the likelihood that an insurer must cover certain losses. See *Kentucky Ass'n of Health Plans, Inc. v Miller* (2003) 538 US 329, 342, 155 L Ed 2 468, 481, 123 S Ct 1471.

The insurer also contended that the commissioner's practice violates the purpose and policy of the ERISA remedial scheme because it effectively eliminates abuse of discretion review by the courts of decisions denying ERISA benefits. However, the Supreme Court has explicitly accepted de novo review of cases involving the denial of benefits under ERISA. *Firestone Tire & Rubber v Bruch* (1989) 489 US 101, 111, 103 L Ed 2d 80, 92, 109 S Ct 948. Because the commissioner's practice does not create a new cause of action or authorize new or different relief, it does not conflict with ERISA. *Rush Prudential HMO, Inc. v Moran* (2002) 536 US 355, 379, 153 L Ed 2d 375, 397, 122 S Ct 2151.

COMMENT: One of the most outrageous inequities of ERISA is that an insurer may insert into its policy a clause providing that an insured may not obtain the benefits of the contract by proving simply that those benefits were wrongfully denied. The insured must prove that the insurer denied the claim arbitrarily and capriciously. This type of clause is permitted by one of the numerous United States Supreme Court decisions on ERISA that are entirely devoid of rationale or logical analysis. In *Firestone Tire & Rubber Co.,* 489 US at 111, the Supreme Court held that ERISA permits insurers to protect themselves when they wrongfully deny claims simply by inserting into the policy the right to deny claims in their discretion. The basis for this decision was that an insurer should be enti-