Its looking a lot like 1989: Changes in the law governing the construction of insurance policies in California

By Jeffrey Isaac Ehrlich

A leading treatise on California insurance litigation warns that it is risky to rely on pre-1990 caselaw concerning the interpretation of insurance policies. (Croskey, Heesman & Johnson, *California Practice Guide – Insurance Litigation* (Rutter 2003 rev.) para. 4:4, p. 4-2.) This is because in 1990, the California Supreme Court decided *AIU Ins. Co. v. Superior Court (FMC Corp.)* (1990) 51 Cal.3rd 807, 274 Cal.Rptr. 820, the first of three decisions generally considered to have effected a sea-change in the law governing insurance contract interpretation. The other two cases are *Bank of the West v. Superior Court (Industrial Indem. Co.)*(1992) 2 Cal. 4th 1254, 10 Cal.Rptr.2d 538, and *Waller v. Truck Ins. Exchange* (1995) 11 Cal.4th 1, 44 Cal.Rtpr. 2d 370. (These three cases will sometimes be referred to as the "*AIU* trilogy."

The Rutter treatise characterizes the *AIU* trilogy as shifting from an approach were "ambiguity was king" to one where "context is king." Since ambiguity in insurance policies tends to produce judicial decisions in favor of the policyholder, a change in the law that made it harder for courts to find that insurance policies were ambiguous was a change that favored the interests of insurers.

The *AIU* trilogy does not, however, represent the Court's last word on the topic of insurance policy interpretation. Since 2001, the California Supreme has decided three more major policy-interpretation cases: *Safeco Ins. Co. v. Robert S.* (2001) 26 Cal.4th 758, 110 Cal.Rptr.2d 844; *MacKinnon v. Truck Ins. Exchange* (2003) 31 Cal.4th 635, 3 Cal.Rtpr.3d 228; and *E.M.M.I. v. Zurich Ins. Exchange* (2004) 32 Cal.4th 465, 9 Cal.Rptr.3d 701. Unlike *AIU, Bank of the West,* and *Waller*, which all arose from disputes concerning interpretation of the coverage clauses in the respective policies at issue, these recent cases all deal with interpretation of policy exclusions.

What is interesting about the progression of the law from 1989 to today is that the principles that the Court has articulated have largely been the same; in fact, the cases the Court relies on are largely the same. The *AIU* trilogy did not overrule or criticize any earlier cases, and the post-2001 decisions do not criticize or distinguish *AIU*, *Bank of the West*, or *Waller*. Yet, just as the *AIU* trilogy changed the approach that California courts used to interpret insurance policies, so too have the recent decisions. While the *AIU* trilogy stressed the fact that insurance policies were contracts, and therefore to be construed using the rules that apply to contracts, the post-2001 decisions place more emphasis on the special rules that apply to the interpretation of insurance policies.

If the *AIU* trilogy urged an approach where "context is king," perhaps it could be said that the Supreme Court's recent decisions stress an approach where the insured's reasonable expectations are king. As a result, the law in this area in 2004 looks much like the law in 1989.

The pre-1990 approach

United Services Automobile Assn. v. Baggett (1989) 209 Cal.App.3d 1387, 1391-1392, 258 Cal.Rptr. 52, contains a typical statement of the law of insurance contract interpretation circa 1989. It explains:

> *Reserve Insurance Co. v. Pisciotta* (1982) 30 Cal.3d 800, 806-807, 180 Cal.Rptr. 628, 640 P.2d 764, articulates established principles of insurance policy interpretation, including: "Words used in an insurance policy are to be interpreted according to the plain meaning which a lay[person] would ordinarily attach to them. Courts will not adopt a strained or absurd interpretation in order to create an ambiguity where none exists." [Citations omitted.] "'Whereas coverage clauses are interpreted broadly so as to afford the greatest possible protection to the insured [citations], exclusionary clauses are interpreted narrowly against the insurer. [Citations.]' ... '[A]n insurer cannot escape its basic duty to insure by means of an exclusionary clause that is unclear.... [T]hus, "the burden rests upon the insurer to phrase exceptions and exclusions in clear and unmistakable language." ...' " [Citations omitted.] Insurance policy terms are construed in the context of the policy and the circumstances of the case and should not be found ambiguous in the abstract. [Citations omitted.] Courts become interested in an insured's reasonable expectations of coverage " 'only where there is an ambiguity in the policy.' [Citations Omitted.]

AIU, Bank of the West, and Waller

The issue in *AIU* was whether a comprehensive general liability ("CGL") policy provided coverage for cleanup and other response costs incurred by the insured under state and federal environmental protection statutes. (More specifically, the issue was whether the coverage clause in the CGL policy provided coverage for these costs. The Court did not consider whether various exclusions in the policy might ultimately preclude coverage.) The Court held that the policy, which provided coverage for all sums the insured becomes legally obligated to pay as "damages" or "ultimate net loss" because of property damage, covered the costs of reimbursing government agencies and complying with injunctions ordering an environmental cleanup.

In reaching these conclusions, the Court restated the rules that govern the interpretation of insurance contracts in California. The Court did not purport to break any new ground in this area. It did not overrule any earlier decisions, or even criticize any earlier cases. It relied on the many of the same authorities as the Court of Appeal did in *Baggett*, cited above. The Court stated the rules in a form that has come to be viewed as a three-part test:

First, the mutual intent of the parties at the time the contract was made governs the interpretation of the contract. (Civil Code § 1636.) This intent it to be inferred, if possible, solely from the written provisions of the contract. (Civil Code § 1639.) The clear and explicit meaning of these provision, interpreted in their ordinary and popular sense will govern, unless the parties used them in a technical sense or gave them a special meaning. "Thus, if the meaning a layperson would ascribe to contract language is not ambiguous, we apply that meaning." (*AIU*,

51 Cal.3d at 831.) The first part of the test, then, is to decide whether the terms used in the policy are clear and ambiguous, when construed according to their plain meaning.

Second, if the terms are ambiguous when the plain-meaning test is applied, then the court should try to resolve the ambiguity by interpreting the ambiguous terms in the way that the the insurer believed that the policyholder understood them when the contract was made. (Civil Code § 1649.) (*AIU*, 51 Cal.3d at 831.)

Third, if the first two tests fail to resolve the ambiguity, the ambiguous language will be construed against the party who caused the uncertainty to exist. (Civil Code § 1654.) In insurance cases, this is generally the insurer. (*AIU*, 51 Cal.3d at 831.)

After articulating these three rules, the *AIU* Court also noted that coverage clauses are generally interpreted broadly, to protect the insured's objectively reasonable expectations. (*Ibid*.)

At the time it was decided, *AIU* did not seem to herald a new era in insurance litigation. But its impact became clear two years later, in *Bank of the West*. The issue in *Bank of the West* was whether a CGL policy that covered damages for advertising injury caused by wrongful competition applied to a claim for "unfair competition" under the State's Unfair Business Practices Act, Bus. & Prof. Code section 17200, et seq. The Court held that it did not.

The policyholder, the bank, had been sued under section 17200. It argued that the policy did not define "unfair competition" and that the term could reasonably be construed to refer to common-law unfair competition, or statutory unfair competition claims. Based on this claimed ambiguity, the bank argued that the rule construing ambiguities against the insurer should be invoked to provide coverage.

Citing *AIU*, the Court explained that, while insurance contracts have special features, they are still contracts to which ordinary rules of construction apply, and that the "fundamental goal" of contractual interpretation is to give effect to the mutual intention of the parties. (*Bank of the West*, 2 Cal.4th at 1264.) The Court next explained that bank's argument was flawed because it was applying the third rule of construction articulated in *AIU* (the rule construing ambiguities against the insurer) too early in the process. (2 Cal.4th at 1264.)

The Court explained that, under *AIU*, a court that is faced with an argument for coverage based on an asserted ambiguity in the policy must first attempt to determine whether coverage is consistent with the insured's objectively reasonable expectations. (*Bank of the West*, 2 Cal.4th at 1265.) In making this determination, the court must interpret the policy language in context, with regard to its intended function in the policy. (*Id*.) "This is because *language in a contract* must be construed in the context of that instrument as a whole, and in the circumstances of the case, and *cannot be found ambiguous in the abstract*." (*Id*., emphasis added.)

In the Court's view, even if the term "unfair competition" was ambiguous standing alone, that ambiguity could be resolved by examining the way the term was used in the context of the policy. The policy did not promise coverage for unfair competition; it covered liability for *damages* for *advertising injury* caused by unfair competition. Read in this context, the Court

concluded that "unfair competition" could only refer to a civil wrong that can support an award of damages, and hence excluded a claim under section 17200, which provides no damages remedy. (2 Cal. 4th at 1265.)

Waller did not seem to break any new ground concerning contract interpretation, but re-emphasized the approach described in *AIU* and *Bank of the West*. When the Supreme Court explains that approach in its new decisions, it tends to cite *Waller*. The issue in *Waller* was whether a CGL policy provided coverage for incidental emotional distress caused by the insured's non-covered economic or business torts. Citing *AIU*, *Bank of the West*, and also *Reserve Ins. Co. v. Pisciotta*, the 1982 decision that the Court of Appeal in *Baggett* cited as the principal authority in this area, the Court articulated the 3-part test.

AIU, *Waller*, and *Bank of the West* all dealt with disputes concerning the meaning of the coverage clause in a CGL policy. While those cases taught that courts needed to construe insurance contracts like contracts, an issue left unresolved in those cases was how to incorporate the special rules that did apply to construction of insurance contracts. For example, where in the three-part test (and how) should a court factor in the rule that coverage clauses would be construed broadly, while exclusions should be construed narrowly? What about the rule requiring exclusions to be phrased in clear and unmistakable language?

Robert S.; MacKinnon;* and *E.M.M.I.

The Court began to address these questions in 2001, with *Safeco v. Robert S.* This case construed an exclusion for "illegal acts" contained in a homeowner's policy. The insured's son accidentally shot and killed a friend, and was convicted in juvenile court of involuntary manslaughter, a felony. The homeowner's carrier contended that, in light of the exclusion in the policy for illegal acts, it had no duty to defend or indemnify its insureds in litigation brought by the decedent's parents.

The trial court granted summary judgment for the insured, finding that the exclusion only applied to intentional illegal acts. The Court of Appeal reversed, finding that the plain meaning of the term "illegal" as demonstrated by its dictionary definition, meant "unlawful" or "not according to or authorized by law." The court concluded that, given this meaning, the exclusion applied to any act in violation of civil or criminal law, and hence did not cover an act resulting in a juvenile court adjudication of involuntary manslaughter. (26 Cal. 4th at 762.)

The Supreme Court reversed. The court first cited the three-prong test, and concluded at step one that the term "illegal" was ambiguous. It could mean either any act prohibited by law or, more narrowly, a criminal act. (*Id.* at 763.) The court rejected the insurer's attempt to rely on the narrower construction, noting that if Safeco had wanted to include a criminal acts exclusion in its policy, it could have done so. Having opted for an illegal acts exclusion, Safeco could not have the court read into the policy what Safeco had omitted. (*Id.* at 764.) To do so, the Court noted, would violate the "fundamental principle" that in construing contracts, including insurance contracts, the court could not insert what had been omitted. (*Id.* at 764.)

Having concluded that the exclusion was ambiguous, the Court then applied the second test, and found that it did not resolve the term's meaning. If the term "illegal act" meant any unlawful act, it would extend to violations of the statutory duty to use due care imposed by Civil Code section 1714; in other words, it would eliminate coverage for any act of simple negligence. This construction would render the policy's grant of coverage illusory, since it would allow the illegal acts exclusion to swallow the policy's grant of coverage for an "accident."

Looking at the insured's reasonable expectations, the Court framed the inquiry as, "Would reasonable insureds expect their homeowner's policy to protect them against liability for accidental injury or death occurring in their home. The answer is yes. (26 Cal.4th at 766.) Because the Court concluded that the illegal acts exclusion could not be given meaning under the established rules of construction of contracts, it was held invalid.

MacKinnon saw the Court returning to the construction of CGL policies. But this time the issue was the meaning of the policies' pollution exclusion, which excluded coverage for injuries caused by the "discharge, disposal, release or escape of pollutants." The insured in *MacKinnon* was a landlord who had been sued by a tenant's heirs following the tenant's death from exposure to pesticides sprayed by a pest-control firm hired by the landlord. The issue to be decided was whether the pest-control firm's conduct amounted to the discharge of pollutants within the terms of the pollution exclusion.

The Court began its analysis by tracing the drafting history of the pollution exclusion. After explaining that its purpose was to prevent CGL coverage from becoming a funding source for environmental cleanups ordered under the newly-enacted environmental statutes in the 1960s, the Court explained, "We would be remiss, therefore, if we were to simply look to the bare words of the exclusion, ignore its raison d'etre, and apply it to situations that do not resemble traditional environmental contamination." (31 Cal.4th at 645.) *MacKinnon* hence shows that reliance on the plain meaning of the words in the contract has its limits.

The Court's discussion of the principles of California law that govern the construction of insurance policies also reveals further tension with the *AIU/Bank of the West/Waller* approach. The opinion contains the standard recitation of the three-part test, principally citing *Waller*. But this discussion is followed immediately by another paragraph citing several principles of construction that apply only to insurance contracts. The Court says:

> [I]nsurance coverage is "interpreted broadly so as to afford the greatest possible protection to the insured, [whereas] ... exclusionary clauses are interpreted narrowly against the insurer." (*White v. Western Title Ins. Co.* (1985) 40 Cal.3d 870, 881, 221 Cal.Rptr. 509, 710 P.2d 309.) "[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*.' " (*State Farm Mut. Auto. Ins. Co. v.*

> *Jacober* (1973) 10 Cal.3d 193, 201-202, 110 Cal.Rptr. 1, 514 P.2d 953, italics in original.) 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. (*Gray v. Zurich Insurance Co., supra,* 65 Cal.2d at pp. 272-273, 54 Cal.Rptr. 104, 419 P.2d 168.) [FN4] The burden is on the insured to establish that the claim is within the basic scope of coverage and on the insurer to establish that the claim is specifically excluded. (*Aydin Corp. v. First State Ins. Co.* (1998) 18 Cal.4th 1183, 1188, 77 Cal.Rptr.2d 537, 959 P.2d 1213.) (*MacKinnon*, 31 Cal.4th at 648.)

This paragraph is interesting because it brings back into the forefront of insurance-policy construction the pre-1990 decisions that the *AIU* trilogy was thought to have displaced. When the Court's analysis moved from the general principles that govern policy interpretation to the specific clause at issue, it noted that dictionary definition of the terms in the pollution exclusion might well support the broad view of the exclusion urged by the insurer, but that a court should not "make a fortress out of the dictionary." (31 Cal.4th at 649. [Citations omitted.])

The Court concluded that a broad construction of the exclusion, which would extend its reach to any injury caused by substances widely understood to be dangerous would undermine the purpose of CGL coverage and lead to unreasonable results. (31 Cal.4th at 654.) And even if the broad definition could be considered reasonable, it was not the *only* reasonable interpretation. Therefore, the exclusion did not plainly and clearly take away the coverage promised by the insuring clause in the CGL policy, and the Court would construe the exclusion in favor of coverage. (31 Cal.4th at 654.)

E.M.M.I. is the most recent Supreme Court decision construing an insurance policy – in that case a jeweler's block insurance policy, which, as its name implies, covers damage or loss of jewelry. The policy contained an exclusion for loss caused by theft from any vehicle, unless the person whose duty it is to attend to the vehicle is "actually in or upon the vehicle." The case turned on the meaning of the term, "in or upon." The insurer argued that it meant the employee must be either in the car, or, if the jewels were being transported by motorcycle, "upon" the motorcycle. Because the loss at issue occurred when the employee was outside of the car, crouching behind it while inspecting the exhaust system, the carrier argued that the exclusion applied.

As in *MacKinnon*, the Court began its recitation of the basic rules by citing the version from *Waller* supplemented with citations to *Robert S.* and *MacKinnon*. As in *MacKinnon*, the Court followed its description of the three-part test with a list of additional, insurance-specific rules of construction, including the rules that exclusions are strictly construed, while exceptions to exclusions are broadly construed; that insurers cannot escape their basic duty to insure by means of an exclusion that is unclear; that any exception to the performance of the basic underlying obligation must be stated in terms that are conspicuous, plain and clear. (32 Cal.4th at 471.)

The insured in *E.M.M.I.* argued that the term "upon" was interchangeable with "on," and that the dictionary definition of "on" included "in close proximity." Hence, there was coverage because the employee was in close proximity to the car when the theft occurred. The insurer countered that "on" meant actually on, such as "on a ship" or "on a train" and "upon" meant up and on, such as "upon" a motorcycle. The Court noted that a policy term need not be deemed ambiguous just because it carries multiple definitions. Rather, the context of the way the word was used in the policy was critical.

Because neither party's preferred construction of the term "in or upon" was consistent with the plain meaning of the term in the way a lay insured would use it, the Court concluded that the exclusion was ambiguous. Having reached this conclusion, the Court resolved the ambiguity in favor of coverage, "consistent with the insured's reasonable expectations." (32 Cal.4th at 474.) The Court went on to find that the exclusion failed the requirement that it be phrased in terms that were plain and clear to the insured.

The majority decision in *E.M.M.I.* drew vigorous dissents from Justices Kennard, and Chin. Justice Brown joined Justice Chin's dissent. Both dissents accuse the majority of straining to find an ambiguity, and of ignoring the plain meaning of the terms in the policy. The dissenting Justices do not accept that a person who is standing behind a car can be thought of as being "upon" it. Hence, the dissents would construe the policy in accordance with what they see as its plain terms, and would go no further.

After the *AIU* trilogy and then *Robert S.*, *MacKinnon*, and *E.M.M.I.*, what is the state of the law of insurance policy construction in California? I would suggest that a succinct, accurate summary can be found in *United Services Automobile Assn. v.* the 1989 decision cited at the beginning of this article. In other words, it would appear that the law has come full circle between 1990 and 2004.

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