Legal Insight

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Insurance Coverage

California Court: Insurer Cannot Avoid Contractual Commitment to Defend Insured Against Federal Criminal Charges

By Paul C. Fuener

Introduction

In an important decision for directors, officers, non-profit executives and other insureds under directors and officers (D&O) and other liability insurance policies, the California Court of Appeal has held that an insurer cannot invoke the California Insurance Code to avoid its contractual obligation to defend its insured against all criminal proceedings. Section 533.5(b) of the California Insurance Code, the Court held, does not prohibit insurers from providing insureds with a defense against all state or federal criminal actions (as the D&O insurer contended), but instead applies more narrowly, barring an insurer-funded defense only of criminal actions brought by four state prosecuting agencies. *See Mt. Hawley Ins. Co. v. Lopez*, No. B234082, 215 Cal. App. 4th 1385, 2013 WL 1818627 (Cal. Ct. App. May 1, 2013). The decision represents a victory for policyholders against improper attempts by insurers to avoid contractual duties to defend based on an overly broad reading of the California Insurance Code.

Background

In January 2010, the United States Attorney for the Central District of California filed a grand jury indictment against Dr. Richard Lopez for criminal conspiracy, false statements, concealment and falsification of records. The indictment alleged that Dr. Lopez, who was the medical director of a liver disease medical center, conspired with another doctor and hospital employees to divert a liver designated for one patient to another patient further down the transplant waiting list, in violation of regulations promulgated under the National Organ Transplant Act, and then covered up his diversion. The indictment further alleged that, as a result of the diversion, the first patient never received a liver and subsequently died.

The Coverage Dispute

The owner of the medical center that employed Dr. Lopez had purchased a non-profit organization executive liability policy from Mt. Hawley Insurance Company. Under the policy, Mt. Hawley agreed to "pay on behalf of the Insureds, Loss which the Insureds are legally obligated to pay as a result of Claims ... against the Insured for Wrongful Acts ...." The policy further provided that Mt. Hawley "shall have the right and duty to defend any Claim covered by this Policy, even if any of the allegations are groundless, false or fraudulent . . . ." By endorsement, the policy defined the term "Claim" to include "a criminal proceeding against any Insured commenced by the return of the indictment." As an employee of the medical center, Dr. Lopez was an "Insured" under the policy.

Dr. Lopez tendered the defense of the federal criminal charges to Mt. Hawley. Mt. Hawley denied any obligation to defend or indemnify Dr. Lopez and filed an action seeking a declaration that it did

not owe Dr. Lopez a duty to defend based on several defenses, including California Insurance Code section 533.5(b). This section of the Insurance Code provides: "No policy of insurance shall provide, or be construed to provide, any duty to defend ... any claim in any criminal action or proceeding or in any action or proceeding brought pursuant to" California's unfair competition and false advertising laws "in which the recovery of a fine, penalty or restitution is sought by the Attorney General, any district attorney, any city prosecutor, or any county counsel, notwithstanding whether the exclusion or exception regarding the duty to defend this type of claim is expressly stated in the policy." The trial court granted summary judgment to Mt. Hawley, finding that section 533.5(b) "unambiguously bars coverage for criminal actions and proceedings," including the federal charges against Dr. Lopez. Dr. Lopez appealed.

The Appellate Court's Decision

On appeal, the California Court of Appeal reversed the trial court's grant of summary judgment to Mt. Hawley, holding that the trial court erred in its broad reading of section 533.5(b). Considering the statutory language, legislative history, maxims of construction, and "reason, practicality, and common sense," the Court of Appeal held that section 533.5(b) applies only to preclude insurers from providing a defense in criminal actions brought by the four state prosecuting entities specifically identified in the statute (i.e., "the Attorney General, any district attorney, any city prosecutor, or any county counsel"). The statute does not bar insurers from defending insureds against civil actions except those brought under California's unfair competition and false advertising laws. Nor does the statute apply at all to bar the defense of any civil or criminal actions brought by federal authorities.

In reaching its decision, the Court recognized that California law may prohibit an insurer from contracting to *indemnify* an insured "for loss caused by the wilful act of the insured." *See* California Insurance Code section 533. However, outside the special area of unfair competition law and the false advertising law actions brought by state and local prosecuting agencies, the Court held, "there is no public policy in California against insurers contracting to provide a *defense* to insureds facing criminal charges ...." (emphasis added).

Conclusion

The *Mt. Hawley* decision represents an important victory for D&O policyholders under California law. The Court's decision affirms D&O insureds' contractual rights to a defense to criminal investigations and proceedings, subject only to the limitations regarding defense of state actions set forth in section 533.5(b). Moreover, the Court's interpretation of section 533.5(b) is consistent with the goal of encouraging individuals to serve as board members and trustees of corporations and charities. As the Court recognized, "[a]llowing insurers to provide for defense costs in criminal cases against corporate agents enhances the ability of for-profit and non-profit organizations to attract directors, trustees, and volunteers who otherwise might hesitate or decline to serve because of a fear of lawsuits and criminal prosecutions." The *Mt. Hawley* court's ruling is also consistent with the fundamental principles that "insureds charged with crimes begin with a presumption of innocence" and that "[t]he law punishes individuals convicted of crimes, not those accused of crimes." In a broader context, the *Mt. Hawley* decision represents a victory for policyholders against increasing attempts by insurers to avoid contractual obligations to provide defense and/or indemnification to policyholders based upon insurers' overly broad and misconceived notions of "public policy." The *Mt. Hawley* court properly rejected Mt. Hawley's attempt to rely on an overly broad conception of section 533.5(b) to avoid its contractual commitment to its insureds.

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