

# Insurance Coverage Update

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## **Lincoln Fountain Villas Homeowners Association vs. State Farm Fire & Casualty Insurance Company**

### ***(Property Insurer's Adjustment of 1994 Northridge Earthquake Loss Did Not Constitute Bad Faith)***

In *Lincoln Foundation Villas Homeowners Assoc. vs. State Farm Fire & Cas. Ins. Co.*, \_\_\_ Cal. App.4th (February 15, 2006), the California Second District Court of Appeal affirmed the trial court's entry of summary judgment in favor of State Farm in connection with a complaint for bad faith filed by Lincoln Foundation Villas Homeowners Association ("Homeowners Association"). The parties' dispute arose out of a claim for earthquake damage submitted by the Homeowners Association as a result of the January 17, 1994 Northridge earthquake. The Homeowners Association was insured under a "Condominium Association" policy issued by State Farm which afforded earthquake coverage for a 16-unit condominium building located at 848 Lincoln Boulevard, Santa Monica. The policy afforded coverage for damage caused by earthquake of \$2,209,693 with a 10% deductible (\$220,969).

In late February, 1994, the Homeowners Association submitted a claim to State Farm for damage to the building and common areas of the complex. Initially, State Farm's claim representative inspected the complex and determined that the damage sustained as a result of the earthquake was below the \$220,969 deductible. As such, State Farm advised the Homeowners Association that it would make no payment on its earthquake damage claim.

Subsequently, the Homeowners Association hired an architectural and engineering consulting firm to prepare its own report regarding damage to the complex as a result of the Northridge earthquake. On July 23, 1994, the Homeowners Association provided State Farm with its consultant's report estimating earthquake damages of \$314,274.06 which included approximately \$90,000 to repair the interiors of condominium units. In response, on August 2, 1994, State Farm retained Pacific Gold Coast Construction Company to prepare a "per-line damage estimate" of the earthquake damage to the complex. On August 29, 1994, Pacific submitted a damage estimate to State Farm totaling \$327,456.56.

State Farm met with the Homeowners Association's consultants and agreed to settle the Association's claim for \$296,585.95. On September 30, 1994, the Homeowners Association was paid \$32,777.53. Thereafter, the Homeowners Association retained a contractor which repaired the damages sustained by the complex for a total of \$128,132.69. On September 25, 1995, the Homeowners Association sent a letter to its members advising that the earthquake repairs to the complex were complete.

As a result of the enactment of California Code of Civil Procedure §340.9 extending the statute of limitations for filing bad faith claims related to the 1994 Northridge earthquake, the Homeowners Association filed a complaint for bad faith against State Farm based on its failure to properly investigate its renewed claim for damages based on subsequently developed earthquake damage information presented by the Homeowners Association. This claim asserted that newly discovered evidence of earthquake damage exceeded \$900,000 for the costs of repair. State Farm rejected the Association's "new claim." As a result, the Homeowner's Association filed a complaint for bad faith. In response, State Farm filed a motion for summary judgment arguing that the Homeowners Association had accepted its payment in settlement of the claim and, in fact, received \$32,777. 53 more than it was entitled to based on its representation that the earthquake damage was repaired for \$128,132.69. The trial court reasoned that the State Farm policy obligated it to pay its insured only the amount necessary to repair earthquake

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damage with equivalent construction or the amount actually spent to repair or replace the damaged property, which ever is less. In this instance, because State Farm had paid the Homeowners Association everything it was due under the insurance contract plus an additional windfall of \$32,777.53, it was not entitled to any further benefits under the State Farm policy. As such, the trial court entered summary judgment in favor of State Farm.

In affirming the trial court's entry of summary judgment, the Court of Appeal rejected three different arguments made by the Homeowners Association. First, the Court of Appeal noted that State Farm did not breach its insurance contract by failing to investigate the homeowners' "newly presented earthquake damage information." The Court of Appeal noted that Code of Civil Procedure §340.9 does not impose a new duty to investigate claims on insurance companies. As respects the Homeowners Association's argument that State Farm ignored repair estimates for earthquake damage nearly three times that of State Farm's own estimates, the Court of Appeal noted that such contention is not supported by any admissible evidence. Rather, the only evidence submitted to support such contention was the declaration of the Homeowners Association's attorney.

Lastly, the Court of Appeal rejected the Homeowners Association's argument that State Farm incorrectly determined the actual cash value of its loss. The Court of Appeal noted that the Homeowners Association negotiated directly with State Farm and agreed on a replacement-cost valuation for damage to the complex. Given the parties' agreement as to the cost of repair, there was no breach of contract, and State Farm did not act in bad faith.

## Benavides vs. State Farm General Insurance Company

*(Absent Coverage for Mold Damage, First Property Insurer Was Not Liable for Negligent Investigation of Claim)*

In *Benavides v. State Farm General Ins. Co.*, \_\_\_ Cal.App.4th \_\_\_ (February 23, 2006), the California Second District Court of Appeal affirmed the judgment entered after a jury trial in favor of State Farm in connection with a claim for mold damage sustained by Benavides. State Farm had denied Benavides' claim based on an exclusion in its policy for "mold, fungus or wet or dryrot."

Benavides purchased a ground floor condominium unit in Santa Monica in 1994. In 2001, mold was found in the exterior walls of the property, including walls adjacent to plaintiff's unit. Subsequent testing revealed mold inside plaintiff's condominium. Thereafter, plaintiff moved out of her condominium and submitted a claim for additional living expense to State Farm which hired a civil engineer to investigate. State Farm later denied plaintiff's claim on the grounds that the mold was an excluded loss which was not caused by a covered peril. Thereafter, Benavides sued State Farm and the owner of an upstairs condominium. Benavides alleged State Farm had failed to properly investigate her claim resulting in an erroneous coverage decision.

Subsequently, a jury found that coverage was not afforded under the State Farm policy for Benavides' claim. However, the jury awarded Benavides \$260,000 in damages for State Farm's "negligent investigation" of such claim.

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In reversing the jury's decision in favor of Benavides, the Court of Appeal held that absent coverage for the loss, State Farm did not breach its contract with Benavides. Hence, Benavides could not maintain a claim for negligent investigation against State Farm. The Court of Appeal stated as follows:

. . . . The relationship between the parties is contractual. The insured's primary right is to receive compensation for covered losses. The insurer's duty is not to unreasonably withhold the payment of benefits due. When, as here, no benefits are due, a negligent investigation does not frustrate the insured's right to the benefits of the contract. The insured who is not entitled to insurance proceeds has suffered no injury as a result of the manner in which the insurer's investigation was conducted.

## California Insurance Guarantee Association vs. WCAB

### *(Guarantee Association is Not Obligated to Reimburse State Agency for Lien Claims Filed With the Workers' Compensation Appeals Board)*

In *California Ins. Guar. Assn. vs. Workers' Compensation Appeals Board*, \_\_ Cal.App.4th \_\_ (February 27, 2006), California Second District Court of Appeal held that lien claims for reimbursement filed with the Workers' Compensation Appeals Board by the State Employment Development Department ("EDD") were not covered by the California Insurance Guarantee Association ("CIGA"). The EDD had paid benefits to disabled workers, Harry White and Francisco Torres. The insurers for White's and Torres' employers were insolvent. As such, the Workers' Compensation Appeals Board held that CIGA was obligated to reimburse the EDD for its lien claims. CIGA petitioned the Court of Appeal for writ of review.

In reversing the Board's decision, the Court of Appeal held that Insurance Code §1063.1(c)(4) defining what constitutes "covered claims" did not encompass lien claims for reimbursement asserted by a governmental agency. Insurance Code §1063.1(c)(4) specifically excludes obligations to any state or to the federal government.

Because the EDD is a department of an agency of the State of California, the Court of Appeal held that its claims for reimbursement do not constitute covered claims under Insurance Code §1063.1(c)(4).

## Tilbury Constructors, Inc. vs. State Compensation Insurance Fund

### *(Policyholder May Not Pursue a Claim for Bad Faith and Breach of Contract Against Workers' Compensation Insurer Based on Insurer's Failure to Pursue Subrogation)*

In *Tilbury Constructors, Inc. v. State Compensation Insurance Fund*, \_\_ Cal.App.4th \_\_ (March 7, 2006), the California Third District Court of Appeal affirmed the trial court's dismissal of Tilbury Constructors, Inc.'s lawsuit ("Tilbury") after sustaining a demurrer brought by State Compensation Insurance Fund ("State Fund") without leave to amend. The parties' dispute arose out of State Fund's compromise of a lien for workers' compensation benefits paid to an employee of Tilbury for \$10,000 when the amount of benefits paid by State Fund under the policy issued to Tilbury exceeded \$500,000. As a result of State Fund's failure to pursue subrogation against the third party causing injury to Tilbury's employee, Tilbury's workers' compensation premiums dramatically increased. Tilbury also relied on the settlement reached between its employee and a third party contractor for injuries sustained by the employee in the amount of \$1.2 million.

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As a result of State Fund's compromise of its lien for a de minimus amount, Tilbury filed an action for breach of contract and bad faith.

In affirming the trial's decision to dismiss Tilbury's lawsuit, the Court of Appeal stated as follows:  
. . . . The right of subrogation is not a duty under the contract, nor can it be transformed into a duty by virtue of tort law. Thus, because the decision of how and when it shall pursue subrogation, including the decision not to pursue subrogation at all, is State Fund's right. Tilbury cannot state a cause of action for tortious breach of the covenant of good faith and fair dealing based on State Fund's alleged failure to diligently and properly pursue its own right.

The Court of Appeal also explained that because the right of subrogation is a discretionary right accorded to State Fund, Tilbury could not maintain a cause of action for breach of contract against State Fund.

## North American Building Maintenance, Inc. vs. Fireman's Fund Insurance Company

### *(Employment Related Practices Liability Exclusion Does Not Apply to Bar Defense of Lawsuit Brought By Employees of an Independent Contractor Against the Insured)*

In *North American Building Maintenance, Inc. v. Fireman's Fund Ins. Co.*, \_\_\_ Cal.App.4th \_\_\_ (March 9, 2006), the California Fifth District Court of Appeal reversed the trial court's entry of summary judgment in favor of Fireman's Fund relative to the duty to defend North American Building Maintenance, Inc. ("NABM") in an underlying lawsuit brought by janitorial employees against Target Stores, Inc. and NABM. The plaintiffs were employees of California Building Management Services ("CBMS"). NABM had contracted with Target Stores to supply janitorial services. In turn, NABM had contracted with CBMS to perform the actual work at the individual Target Stores, including those in Santa Barbara County.

In September of 2002, three former janitorial workers at a Target Store in Santa Barbara filed a First Amended Class Action complaint for damages and injunctive relief against Target and North American Building Maintenance, Inc. dba California Building Management Services. The complaint alleged eleven causes of action including one for false imprisonment. Subsequently, NABM tendered the defense of the lawsuit to Fireman's Fund, arguing that the cause of action for false imprisonment triggered personal injury coverage under the Fireman's Fund policy. In response, Fireman's Fund denied coverage of NABM for the lawsuit based, in part, on the argument that the "Employment Related Practices Liability Exclusion" ("EPL Exclusion") applied to bar coverage of such lawsuit. In response, NABM sent a letter to Fireman's Fund advising that the plaintiffs were not NABM employees. Rather, they were actually employees of an independent contractor, CBMS. Subsequently, plaintiffs amended their complaint to reflect the fact that CBMS was an independent contractor. Nonetheless, Fireman's Fund continued to deny coverage of the underlying class action lawsuit based on the argument that the EPL Exclusion barred coverage for actions which are employment related and for which the insured "maybe liable as an employer or in any other capacity."

Fireman's Fund filed a motion for summary judgment in response to NABM's lawsuit. The trial court granted such summary judgment holding that potential coverage was not afforded to NABM under Fireman's Fund's policy because the only potential liability in the underlying lawsuit, as a matter of law, could only have been related to NABM's status as an employer of the complaining janitors.

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In reversing the trial court, the Court of Appeal noted that NABM could have been held liable in the underlying lawsuit for the tort of false imprisonment. Further, the Court of Appeal noted that a claim for false imprisonment is a "generic, not an employment-specific tort". None of the elements of the tort require an employment-related showing.

The Court of Appeal also found that the EPL Exclusion does not apply to employees of independent contractors retained by the insured. Rather, in order for the EPL Exclusion to apply, the plaintiffs must have been prospective, present or former employees of the policyholder seeking coverage under the policy.

In concluding that the EPL Exclusion was ambiguous when applied to the facts of the underlying lawsuit, the Court of Appeal stated as follows:

As NABM points out, the other language of the EPL exclusion relates primarily to claims that could only arise in situations of employment, former employment, or prospective employment. The exclusion states the insurance does not apply to personal injury to a person arising out of any "[refusal to employ that person[,] [¶] [t]ermination of that person's employment[,] or [¶] [e]mployment-related practices ..., such as [c]oercion, demotion, evaluation, reassignment, discipline, defamation, harassment, humiliation or discrimination directed at that person . . . ." Certainly, a commonsense and, thus, a reasonable understanding of this category of claims is that it relates to actual, former, or prospective employment.

## Oak Park Calabasas Condominium Association vs. State Farm Fire and Casualty Company

### *(Definition of Wrongful Act as Relating to Negligent Acts, Errors, or Omissions Did Not Encompass Damages Awarded for Breach of Contract by Condominium Association)*

In *Oak Park Calabasas Condominium Assoc. v. State Farm Fire and Cas. Co.*, \_\_\_ Cal.App.4th \_\_\_ (March 9, 2006), the California Second District Court of Appeal affirmed the trial court's entry of judgment in favor of State Farm in connection with an underlying lawsuit filed by a construction company to recover on the cost of repairing a condominium complex which had sustained damage after the 1994 Northridge earthquake.

Oak Park Calabasas Condominium Association ("Oak Park") contracted with the construction company to repair damaged structures within the condominium complex. Subsequently, Oak Park refused to pay the remaining amounts due under the contract. The contractor recorded a mechanic's lien on the Oak Park complex on June 1, 1995. In July, 1995, the contractor filed an action against Oak Park and the owners of the condominiums alleging causes of action for breach of written contract, foreclosure of mechanic's lien, reasonable value of services rendered, failure to release retention proceeds in violation of Civil Code §3260 and fraud.

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Oak Park tendered the defense of the contractor's action to State Farm under a "Directors and Officers Liability Coverage Part" included with the liability policy insuring the condominium association. The Directors and Officers Liability Coverage Part afforded coverage for damages because of wrongful acts committed by an insured solely in the conduct of their management responsibilities for the condominium association. The policy defined "wrongful acts" as follows:

- a. "Wrongful acts means any negligent acts, errors, omissions or breach of duty directly related to the operation of the condominium association."

The trial court entered judgment in favor of State Farm and held that the underlying contractor's lawsuit for breach of contract did not constitute a "wrongful act" as that term was defined in the State Farm policy.

In affirming the trial court's decision, the Court of Appeal stated as follows:

We observe that there are few California appellate decisions dealing with D&O policies. As a consequence, California courts often look to decisions of California federal courts and out-of-state cases in resolving coverage issues and interpreting policy provisions. (*ML Direct, Inc. v. TIA Specialty Insurance Company* (2000) 79 Cal.App.4th 137, 144.) In *Group Voyagers, Inc. v. Employers Insurance of Wausau* (N.D. Cal. Mar. 4, 2002, No. C01-0400 SI) 2002 U.S. Dist. Lexis 3674, the court had occasion to consider the meaning of the phrase "negligent act, error or omission" and specifically addressed the question of whether the term "negligent" applies to all three of the subsequent nouns in the insuring agreement. The plaintiff argued that the word "negligent" only modified the word immediately following it, ("act") and not the words "errors or omissions." The plaintiff had emphasized that the comma following the word "act" indicated a separation between the phrase "negligent act" and "error or omission." The court found such construction to be unreasonable by stating: "The Court is not persuaded by this logic, because the phrase would be ungrammatical without the comma, thus the comma serves the purpose of separating elements of a list. The comma's presence, therefore, cannot fairly be construed to weigh in favor of plaintiff's interpretation of 'negligent act, error or omission.' The Court finds, therefore, that 'negligent act, error or omission' means 'negligent act, negligent error or negligent omission.'" The court further indicated that plaintiff's strained reading of the policy would have provided coverage for every "negligent act" and every "error or omission," whether negligent or intentional. The court noted that such an interpretation would be self-defeating because any intentional conduct could simply be characterized as an "error or omission" rather than an "act" thereby triggering coverage. The Ninth Circuit Court of Appeal affirmed the grant of summary judgment in favor of the insurer. (*Group Voyagers, Inc. V. Employers Insurance of Wausau, supra*, 66 Fed.Appx. 740 (9<sup>th</sup> Cir. Cal.) Jun 4, 2003 U.S. App. Lexis 11366.) The case involved a claim that an employer wrongfully

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failed to pay 401(k) and retirement benefits. In affirming the grant of summary judgment, the Ninth Circuit noted that even a claim of potential error in drafting or interpreting a plan document does not necessarily transform a plan administrator's deliberate decision not to pay benefits into a negligent error in the administration of the plan for purposes of triggering coverage. It cited with approval *Baylor Heating & Air Conditioning, Inc. v. Federated Mut., Ins. Co.* (7<sup>th</sup> Cir. 1993) 987 F.2d 415m 419.

Oak Park and State Farm engaged in exotic rules of grammar to argue their respective positions on appeal, but we see no reason to resort to such devices in resolving the matter. First, it appears to this court that if Oak Park's construction of the policy were correct, any condominium association could choose to enter a reconstruction, remodeling or renovation contract with a contractor, then decide not to pay the bill, thus shifting the obligation to its insurer. No rational insurer would wish to undertake such an insuring obligation. It would be literally impossible, from an actuarial standpoint, to set appropriate premiums to guard against the risk that an association would enter into multimillion-dollar construction contracts, and then not pay for the construction work. That type of risk would be virtually impossible to underwrite.

Second this court is convinced that the concept of fortuity requires a disposition that favors State Farm. Oak Park has alleged nothing which was unanticipated from the standpoint of its position as an insured. The contract that Oak Park entered into was voluntary as was the amendment to the contract and the assignment of insurance proceeds. Oak Park simply chose not to pay all the money due and owing to EEC.

## TIG Insurance Company Of Michigan vs. Home Store, Inc.

### *(Rescission of Directors and Officers Policy Applied to All Officers and Directors, Rather Than Sole Officer Which Misrepresented Financial Condition of the Company)*

In *TIG Ins. Co. of Mich. v. Home Store, Inc., et al.*, \_\_\_ Cal.App.4th \_\_\_ (March 13, 2006), the California Second District Court of Appeal affirmed the trial court's entry of summary judgment in favor of TIG in connection with its rescission of an excess D&O policy issued to Home Stores, Inc. for the period of August 2001 to August 2002. In deciding whether to issue its excess D&O policy, TIG relied on a March 31, 2001 Form 10-Q (Quarterly Financial Report) submitted with its application. Further, the application was signed by Home Store's former Chief Financial Officer, Joseph Shew. In September, 2002, the United States Attorney General filed a criminal information alleging a scheme to commit securities fraud and naming Mr. Shew along with two other former Home Store officers as defendants. Shew pleaded guilty to one count of conspiracy to commit securities fraud and admitted that from March through December 2001 he had conspired to overstate Home Store's advertising revenue and filed false quarterly financial reports with the Securities and Exchange Commission. On February 21, 2003, TIG filed a complaint in Los Angeles County Superior Court for rescission of its excess D&O policy. Essentially, TIG alleged that it was entitled to rescission because former Officer Shew knew the Form 10-Q submitted in support of Home Store's application for insurance contained material misrepresentations which TIG relied upon in deciding to issue its policy. Subsequently, TIG filed a motion for summary judgment. The trial court granted such motion.

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On appeal, Home Store and various officers which did not sign the application for D&O excess insurance argued that the policy should only be rescinded as to the party which made the actual misrepresentations, i.e., Mr. Shew. In affirming the trial court's decision, the Court of Appeal noted that the language in the policy stated that material misrepresentations voided the policy in its entirety. The policy does not state that the policy will be void only as to the particular signer who had knowledge of the misrepresented facts. The Court of Appeal also noted that Insurance Code §650 supported TIG's right to rescind the policy in its entirety as to signers and innocent non-signers.

In addition, the Court of Appeal held that the rescission provision in the TIG policy is not subject to the heightened standard applied under California law to exclusions and termination provisions. Lastly, the Court of Appeal held that the false misrepresentations of fact contained in the Home Store Quarterly Financial Report were material to the acceptance of the risk as a matter of law.

## National Casualty Company vs. Sovereign General Insurance Services, Inc.

*(Letter Encompassing a Claim Mailed From London to a Policyholder in Stockton, California Satisfied the Territorial Requirement in a Claims Made Policy that a Claim Must First Be Brought Within the United States. Further, "Claim First Brought" Did Not Refer to Institution of a Legal Action)*

In *National Cas. Co. v. Sovereign General Ins. Services, Inc.*, \_\_\_ Cal.App.4th \_\_\_ (March 14, 2006), the California Third District Court of Appeal affirmed the trial court's judgment in favor of Sovereign in connection with a dispute as to whether its errors and omissions policy afforded coverage for a claim for arbitration asserted by certain underwriters at Lloyd's London ("Lloyd's") against Sovereign in connection with its handling of underwriting and claims under Lloyd's policies. National issued a "wholesaler, underwriting manager and managing general agent errors or omissions liability policy" to Sovereign for the period of August 17, 2000 to August 17, 2001. The policy afforded coverage on a claims made basis. Coverage applied only to those claims that are first made during the policy period and any extended reporting period. Under the heading "Where and When We Insure" and the subheading "Where We Insure" the policy stated:

This policy applies to a wrongful act committed anywhere in the world provided that the claim is first brought in the United States of America (including its territories and possessions), Puerto Rico or Canada.

The policy only applied when a written claim is first made against the insured during the policy period. The policy defined "claim" as follows"

A demand or assertion of a legal right seeking damages made against any of you. A claim includes an arbitration proceeding to which any of you is required to submit or to which any of you has submitted with our consent.

On March 20, 2001, Sovereign received a letter from Lloyd's mailed from London to its offices in Stockton, California. The letter advised Sovereign that Lloyd's had suffered a loss as a result of Sovereign's mishandling of underwriting and claims duties under contracts between Sovereign and Lloyd's. The letter also advised Sovereign that Lloyd's intended to recover all losses arising out of its conduct. Lastly, the letter advised that Sovereign should notify its professional insurer as soon as possible. Subsequently, Sovereign placed National on notice of the Lloyd's letter.

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Approximately one year later, Lloyd's attorney sent another letter to Sovereign. The letter referenced the arbitration clause in the agreements between Lloyd's and Sovereign, and demanded arbitration of the contested agreements. A few days later, attorneys for Lloyd's sent another letter demanding the sum of \$5.0 million to settle its claim against Sovereign. This letter was sent from Lloyd's attorney's office in Los Angeles.

National agreed to defend Sovereign in connection with the Lloyd's arbitration demand but noted that coverage may not be afforded under its policy because the initial claim letter sent by Lloyd's was from London, and outside the territorial limitation in the National policy. Subsequently, National filed a complaint for declaratory relief arguing that the phrase "claim first brought" contained in the policy referred to the filing of a formal legal action. Since the arbitration in this matter was commenced in London, the claim was first brought outside the United States.

In rejecting National's position, the Court of Appeal noted that National did not contest the point that the foundational claim was first made during the National policy period and received by Sovereign at its offices in Stockton, California. The Court of Appeal also rejected National's argument that the term "claim" referred only to a formal legal action. Rather, the Court noted that the definition of claim in the National policy is more expansive and included a demand or an assertion of a legal right seeking damages. As such, Lloyd's first letter of March 20, 2001 satisfied the definition of claim in the National policy. Further, since the letter was received by Sovereign in the United States, it satisfied the territorial limitations set forth in the National policy.

Lastly, the Court of Appeal held that the phrase "claim first brought" also referred to a claim first being made during the policy period. As such, Sovereign's receipt of the March 20, 2001 letter from Lloyd's satisfied the policy requirements for claims first made and first brought during the policy period.



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