IN THE COURT OF APPEAL

OF THE STATE OF CALIFORNIA

SECOND APPELLATE DISTRINCT

TRUCK INSURANCE EXCHANGE, a reciprocal or inter-insurance exchange, and FARMERS GROUP, INC., dba FARMERS UNDERWRITERS ASSOCIATION, a reciprocal inter-insurance exchange or its Attorney-in-fact, Petitioners, vs. SUPERIOR COURT OF THE STATE OF CALIFORNIA, FOR THE COUNTY OF LOS ANGELES, Respondent.	) 2nd Civil No. B 117294) (Los Angeles Superior Court Case No. BC090825, c/w BC135685) Honorable Harold I. Cherness, Judge)
PECK/JONES CONSTRUCTION CORPORATION, a California corporation, and JERVE M. JONES, an individual, Real Parties in Interest	

UNITED POLICYHOLDERS AMICUS BRIEF IN SUPPORT OF PETITION FOR REHEARING

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TABLE OF CONTENTS

		Page
I.	WHY THE COURT SHOULD RECONSIDER ITS MARCH 26 DECISION	1
II.	THE BREACH OF CONTRACT VS. TORT DISTINCTION VIOLATES CALIFORNIA'S FUNDAMENTAL RULES OF POLICY CONSTRUCTION	4
	A. UNDER THE "PLAIN MEANING" RULE, THE TERMS "LEGALLY OBLIGATED" AND "LIABILITY IMPOSED BY LAW" SIMPLY DO NOT AFFECT COVERAGE FOR LIABILITIES IN CONTRACT	4
	1. OUR IS THE "ORDINARY AND POPULAR" MEANING	4
	2. THE CASELAW SUPPORTS THIS INTERPRETATION.	13
	3. EVEN THE INSURANCE INDUSTRY UNDERSTANDS AND APPLIES THIS MEANING.	16
	4. CONCLUSIONS REGARDING THE "PLAIN MEANING" RULE: "LEGALLY OBLIGATED" AND "LIABILITY IMPOSED BY LAW" DO NOT PRECLUDE COVERAGE FOR LIABILITIES IN CONTRACT, BUT OTHER POLICY PROVISIONS DO NARROW COVERAGE SIGNIFICANTLY	20
	B. INTERPRETING "LEGALLY OBLIGATED" UNDER THE "OBJECTIVE REASONABLE EXPECTATIONS OF THE INSURED" RULE: MANY POLICY PROVISIONS CLEARLY REFLECT COVERAGE FOR CERTAIN LIABILITIES IN CONTRACT	22
	C. INTERPRETING "LEGALLY OBLIGATED" UNDER THE CONTRA-INSURER RULE	25
III.	THE DEVONSHIRE LINE OF CASES RUNS COMPLETELY CONTRARY TO THE LONG-ESTABLISHED BODY OF CALIFORNIA CASELAW UPHOLDING COVERAGE FOR WHAT WERE CLEARLY LIABILITIES IN CONTRACT	25

IV. HOW THE DEVONSHIRE LINE OF CASES REACHED THE WRONG INTERPRETATION OF "LEGALLY OBLIGATED" 29

CONCLUSION 33

TABLE OF AUTHORITIES

Page

CASES

Action Aids, Inc. v. Great American Ins. Co. (Wy. 1984) 685 P.2d 42 — 11

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Assurance Co. of America v. Haven (1995) 32 Cal. App. 4th 78 — 6

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Fragomeno v. Insurance Co. of the West (1989) 207 Cal. App. 3d 822 — 5, 32

Girard v. Commercial Standard Ins. Co. (1944) 66 Cal. App. 2d 483 — 13

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Montrose Chemical Corp. v. Admiral Ins. Co. (1995) 10 Cal. 4th 645 17

Montrose Chemical Corp. v. Admiral Ins. Co. (1992) 35 Cal. App. 4th 335 17

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Ritchie v. Anchor Cas. Co. (1955) 125 Cal. App. 2d 145 13, 29 30, 31, 32

Rivere v. Heroman (La. App. 1997) 688 So.2d 1293 18

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I. WHY THE COURT SHOULD RECONSIDER ITS MARCH 26 DECISION

Rehearing in this matter should be granted because an issue of critical importance was not adequately briefed by the parties herein. Further, rehearing is warranted because the Court's March 26, 1998 decision inadvertently misstated a material issue of law.

This appeal raises an issue of multi-billion dollar significance to commercial entities of all sizes doing business in California. That issue is: Shall commercial general liability ("CGL") policies be deemed to completeley and categorically avoid covering liabilities that bear any relationship to a contract, no matter how attenuated? Or, is coverage for such liabilities determined by operation of the relevant provisions in individual policies? While the latter is the accurate statement of the law, we believe the court's March 26 decision actually states the former.

We are writing as *amicus curaie* to provide this court with information that is pivotal to a proper determination of the legal issue at bar. Unfortunately, the Real Parties in Interest completely failed to brief this critical issue, depriving this court of the benefit of a thorough analysis from the policyholder's perspective. As a result, the court adopted Petitioner Truck Insurance Exchange's overly broad and therefore incorrect contention that any liability related in any way to a contract is completely and categorically outside the coverage of CGL policies.

The overbreadth of Petitioner's contention as adopted by the court lies in the fact that although CGL policies do not cover losses arising *solely* from a breach of contract, and nothing more, they *do* cover liability for bodily injury or property damage. The correct statement of law is: Where a claim may be construed as seeking recovery for

property damage or bodily injury, it cannot be treated as being purely a "breach of contract" claim, even if it arises from a contractual performance. The critical inquiry for determining coverage is whether or not bodily injury or property damage has occurred, not whether it resulted from a breach of contract or from a tort.

There are common instances where breach of contract may result in bodily injury or property damage. One such example would be where a policyholder enters into a contract to provide security at an event. A claim is made by an attendee injured at the event due to inadequate security. The policyholder committed a breach of contract (by failing to provide adequate security) that resulted in bodily injury. The fact that the liability arises from a breach of contract in this example does not mean the policyholder will have no coverage under a typical CGL policy and under existing law for the bodily injury. Coverage is not controlled by the labels of "contract" vs. "tort," but instead by the nature of the alleged injury sustained (e.g., whether there was "propety damage" or "bodily injury"). This example shows that Petitioner's broad statement that there can be no coverage for liabilities related in any way to a breach of contract is simply incorrect.

There is a real danger that insurance companies will misuse this court's March 26 decision to assert that the "contract" label is categorical and definitive as to coverage in every case. This would result in a wholesale negation of existing, carefully drafted coverage.

The stakes in this matter are very high. We estimate that California businesses of all sizes actually pay an average of 33% of their CGL premium dollars to obtain the specific coverage at issue. This translates into billions of dollars to California businesses

each year. The negotiated, paid for, promised, and expected coverage for which these companies have been paying will be defeated by the continued publication of this court's March 26 decision.

If the opinion stands and is published as written, its impact will eventually bankrupt a large number of California companies. These companies prudently bought this coverage because it protected them against certain contract-based liabilities which constitute a serious, very common exposure. The wording to the March 26 decision would also devastate those thousands of injured claimants who, as contracting parties, anticipated the need for the coverage at issue and required it to be purchased as a condition of their entering into the contract. Purchasers of CGL coverage and the parties with whom they contract have reasonably relied on and paid dearly for, insurance companies' promises to provide coverage for the limited contract-based liabilities in question. They should not be deprived of the benefits for which they bargained.

United Policyholders is a non-profit insurance educational organization devoted to raising insurance coverage issues that affect the rights of policyholders, including business policyholders such as those involved in this case. Our interest in this case is in upholding the basic rules of policy construction and protecting policyholders' rights to their reasonable expectations of coverage for certain, long-covered liabilities in contract.

For the foregoing reasons, we ask that the court consider the important legal issues and authorities raised hereinbelow, before publishing a decision that will devastate California businesses and claimants alike.

II. THE BREACH OF CONTRACT VS. TORT DISTINCTION VIOLATES CALIFORNIA'S FUNDAMENTAL RULES OF POLICY CONSTRUCTION

Truck Insurance Exchange contends that the categorical preclusion it advocates arises out of that part of the CGL insuring agreement requiring that either the policyholder be "legally obligated" to pay the damages in question or that the liability be "imposed by law." Truck Insurance Exchange argues that these alternative provisions limit coverage to liabilities in tort, thereby completely precluding coverage for liabilities in contract. This contention arises out of a line of cases starting with *International Surplus Lines Co. v. Devonshire Coverage Corp. (1979) 93 Cal. App. 3d 601 ("Devonshire").* We shall refer to *Devonshire* and its progeny as the "Devonshire Line of Cases."

Under California insurance law, policy terms are interpreted under the following rules, and according to the following sequence of rules: (1) the "Plain Meaning" Rule, (2) the "Objective Reasonable Expectations of the Insured" Rule, and (3) the "Contra-Insurer" Rule.

A. UNDER THE "PLAIN MEANING RULE", THE TERMS "LEGALLY OBLIGATED" AND "LIABILITY IMPOSED BY LAW" SIMPLY DO NOT AFFECT COVERAGE FOR LIABILITIES IN CONTRACT

1. OURS IS THE "ORDINARY AND POPULAR" MEANING

A layperson would unquestionably interpret the terms "legally obligated" and

"liability imposed by law"[1] to include any liability in contract enforceable in a court of law. That is, if one were to ask a layperson if he or she were "legally obligated" to perform his or her responsibilities under a contract, the answer would certainly be yes. Thus, construing "legally obligated" to encompass only tort liability is an overly technical and legalistic interpretation. On this point, Justice Johnson's dissent in one of the Devonshire line of cases, *Fragomeno v. Insurance Company of the West (1989) 207 Cal. App. 3d 822,* observes as follows:

> [T]he majority . . . choose[s] to follow cases holding the policy language is properly construed to cover only tort, as opposed to contract liability. (See *Fireman's Fund Ins. Co. v. City of Turlock (1985) 170 Cal. App. 3d 988, 997-998 [216 Cal. Rptr. 796]; International Surplus Lines Co. v. Devonshire Coverage Corp. (1989) 93 Cal. App. 3d 601, 611 [155 Cal. Rptr. 870].)* . . . .
>
> "In both *Fireman's Fund* and *International Surplus,* the Courts of Appeal concluded the phrase 'shall become legally obligated to pay as damages' is the functional equivalent of 'damages for liability imposed by law' which in turn, refers to damages

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[1]For convenience, we will generally combine our discussion of these equivalent provisions, using the "legally obligated" terminology alone. That is the phraseology in the current standard CGL policy, so the vast majority of policies contain it.

which are 'ex delicto' rather than 'ex contractu.' (*Ibid*). The courts therefore conclude contract damages are excluded under this language. *Such a hypertechnical construction violates the most elementary rule of construction for policy language. 'The policy should be read as a layman would read it and not as it might be analyzed by an attorney or an insurance expert.'* [Citations.] At the very least this language is ambiguous, thereby necessitating courts to construe it against the insurer." *Id.*, at pp. 832-833, emphasis added.)

Even renown advocates for the insurance industry concur in this analysis. In their insurance coverage treatise, Guy Kornblum[2] and William Cerillo not only criticize the interpretation given by the Devonshire line of cases but also indicate what the "plain meaning" of "legally obligated" actually is:

"There is another alternative which the [*Devonshire*

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[2]Mr. Kornblum is co-author of Kornblum, et al., California Practice Guide: Bad Faith (1988-1992). His writings have often been looked to for guidance by the California courts. (E.g., *Newman v. Emerson Radio Corp. (1989) 48 Cal.3d 973, 987 (a "noted treatise in the area"); Foley v. Interactive Data Corp. (1988) 47 Cal. 3d 654, 706; Pelkey v. Allstate Ins. Co. (1998) 60 Cal. App. 4th 898, 908; Assurance Co. of America v. Haven (1995) 32 Cal. App. 4th 78, 88; Zeitounian v. Farmers Ins. Group (1994) 25 Cal. App. 4th 929, 946; McLaughlin v. National Union Fire Ins. Co. (1994) 23 Cal. App. 4th 1132, 1166; Fire Insurance Exchange v. Superior Court (1993) 17 Cal. App. 4th 901, 907; State Farm Mut. Auto. Ins. Co. v. Superior Court (1991) 228 Cal. App.3d 721, 725; Jacobs v. Fire Insurance Exchange (1991) 227 Cal. App. 3d 584, 587; Love v. Fire Insurance Exchange (1990) 221 Cal. App. 3d 1136, 1149.)*

line of cases and their out-of-state counterparts] ignore -- that a policy covering sums that the insured may become 'legally obligated to pay' may be given an interpretation that does not rest upon the distinction between tort and contractual liabilities. One commentator writes 'Liability imposed by law for damages or damages which the insured becomes 'legally obligated' to pay, excludes the concept of liability which the insured may have voluntarily assumed . . .' In other words, limiting the 'legally obligated to pay' language to liabilities voluntarily assumed by an insured is not only easier to pinpoint and apply but makes subjective sense. That is, *an insured is as 'legally obligated to pay' a judgment based on a breach of contract as a judgment based on a commission of a tort.*" (Kornblum & Cerrillo, Litigating Insurance Claims: Coverage, Bad Faith, and Business Disputes (1993) §3.11, p. 105, emphasis added.)

Commentator Allan D. Windt, who also regularly represents insurance companies, while reporting on the handful of *ex contractu-ex delicto* cases, strongly criticizes the holdings in those cases:

"The question also arises as to how far the 'no coverage for breach of contract,' rule set forth above, can be extended. It has been held that a negligence claim is not covered if it arises out of a breach of contract. *The foregoing rule is not justifiable. If there has been an occurrence of property damage, and no exclusion applies, there should be coverage."* 2 Windt, Insurance Claims and Disputes (3rd ed. 1995) §11.07, pp. 228-229.)[3]

Edward J. Zulkey, another coverage attorney who regularly represents insurance companies, likewise confirms the proper analysis:

"A frequent source of confusion in the field of insurance coverage interpretation has to do with whether causes of action which sound solely in breach of contract are covered by a CGL policy. The confusion is compounded when the issue is discussed generically (i.e., without reference to policy language.) Unfortunately, certain courts have added to the confusion by rendering decisions without

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[3]The court's March 26 opinion cites Windt as supporting the ***ex contractu-ex delicto*** distinction. However, the passage cited from Windt was merely reporting on what a few courts had held on the issue. As you can see, Mr. Windt's own opinion of the issue clearly supports our position.

reference to policy language. Simply stated, whether breach of contract is covered depends, not on the nature of the cause of action, but whether there was 'bodily injury' or 'property damage' caused by an 'occurrence,' and not otherwise excluded.

The CGL policy, both old form and new, covers 'bodily injury' and 'property damage' caused by an 'occurrence'. It is, of course, normally in alleged property damage cases which involve the breach of contract confusion. Moreover, the requirement of the policy that 'property damage' be caused by an 'occurrence' means that the 'property damage' itself cannot constitute the 'occurrence'. The CGL policy contains only one exclusion which, even remotely, involves liability for breach of contract (usually exclusion [a]). That exclusion however actually involves liability assumed under contract, not breach of contract. *Thus, the CGL policy is silent about liability for breach of contract.*

It is true that most breach of contract cases are not covered under the CGL policy, but that is because there is no "occurrence" or "property

damage" [or because of the operation of an exclusion], not because the cause of action sounded in breach of contract. While a few cases have seemingly been decided on the general basis of whether breach of contract is covered, a review of those cases will indicate that they would have been better decided under a traditional analysis of whether there was 'occurrence' or 'property damage.' Two cases provide a good illustration.

In *Fireman's Fund v. City of Turlock*, 216 Cal. Rptr. 796 (Cal. App. 1995), (discussed above,) the City was successfully sued by an employee for breach of an agreement in which the City had promised to keep confidential the employee's resignation. The employee won his lawsuit on a breach of contract theory, and the damages were recovered for the employee's emotional distress proximately caused by the breach of contract. The City thereafter filed a declaratory judgment action against Fireman's Fund, the City's general liability carrier and U.S. Fire, its excess carrier. The Court analyzed whether the City's liability in the

underlying breach of contract resulted from an occurrence in which the City became 'legally obligated to pay . . . damages'. The court found dispositive the fact that absent the contract between the City and the employee, the insured (i.e., the City) could not have been found liable and hence its liability depended upon the existence of a contractual duty. For this reason, the Court held that there was no coverage under the general liability policy issued by Fireman's Fund because coverage was limited to tort liability, or in other words, a sum which the insured 'shall be legally obligated to pay as damages'. Rather than address whether there was an 'occurrence' or 'property damage,' the court construed the obligation 'to pay damages' as referring to liability ex delicto as opposed to ex contractu. Although reaching the proper result, the court chose to interpret the policy outside the four corners of the contract, a course which should not be favored by insurers.

In *Action Aids, Inc. v. Great American Insurance Company,* 685 P.2d 42 (Wy. 1984), the

Supreme Court of Wyoming decided in a declaratory judgment case that contractual liability is not covered when it could have construed the policy on a traditional basis. Plaintiff was injured in a gas explosion and sued his employer for failure to procure medical insurance as required by the employment contract. The employer had a CGL policy with the standard insuring clause. Because there was an explosion with injury, the Court apparently felt, although not stated, that there was an 'occurrence' and 'bodily injury'. It decided, however, that the policy did not cover contractual liability. An analysis based on the policy language would have reached the same conclusion but for the reason that the damages sought against the employer arose from the failure to procure medical insurance, not from an occurrence causing bodily injury.

In summary, CGL policies, do not differentiate claims based on the cause of action, but rather provide or do not provide coverage based on whether the alleged event fits within its terms. Cases which attempt to premise coverage on general

principles rather than contract language, or the lack thereof, must be reviewed carefully. (Zulkey, Note, 1 CGL Reporter (19__) 310-8 thru 310-10, emphasis added.)

Even if the phrase "legally obligated" raises some doubt in the minds of those who are legally trained, it would be sophistry to conclude that this succeeds in incorporating the highly arcane *ex contractu-ex delicto* distinction into the policy with sufficient clarity that a layperson is alerted to the drastic narrowing of coverage which would result. Thus, the "plain meaning" of "legally obligated" to a layperson clearly includes liability in contract.

2. THE CASELAW SUPPORTS THIS INTERPRETATION

The seminal case in this area, *Ritchie v. Anchor Cas. Co. (1955) 135 Cal. App. 2d 145 ("Ritchie")*, explains the true meaning of the term "legally imposed by law" (which thereby explains the meaning of "legally obligated"). The *Ritchie* court begins its analysis, at 135 Cal. App. 3d 254, by reciting the general rule from *Girard v. Commercial Standard Ins. Co. (1944) 66 Cal. App. 2d 483, 490,* that "the term 'liability imposed by law,' when used in connection with liability insurance, is ordinarily construed as meaning liability imposed in a definite sum by a final judgment against the insured."[4] That is, this portion of the insuring agreement (whether phrased as "liability imposed by law" or "legally obligated to pay"), clearly and explicitly means to preclude the

[4]The *Ritchie* court then went on to depart from this general rule for the reasons discussed in III. below, which departure was appropriate for the particular policy language it was faced with there.

policyholder from *voluntarily accepting a liability* on a claim prior to a final determination of that liability at trial. (At least not without the insurance company's prior consent.) Insurance companies do not want policyholders to settle claims for which they have no liability and then turn to the insurance company for payment. For example, an insured business may be eager to resolve a small claim from its biggest customer out of good will concerns, even though there is no actual legal basis for the customer's claim.

The California Supreme Court has also recently spoken in this area. In *AIU Ins. Co. v. Superior Court (1990) 51 Cal. 3d 807,* the insurance company denied coverage, claiming that injunctions and response costs under CERCLA were equitable, not "legal" obligations. The court held that those were covered "legal obligations," reasoning as follows:

> "Because California has generally abandoned the traditional distinction between courts of equity and courts of law (see Code Civ. Proc. §§24, 30; *Aerojet[-General Corp. v. Superior Court] 210 Cal. App. 2d 216, supra,* 21 Cal. App. 3d at pp. 230-231, fn.8), even a legally sophisticated policyholder may not anticipate that the term 'legally obligated' precludes coverage of equitably compelled expenses. *Because the relief is ordered by a court of law, as that term is used in the modern sense, [the insured] could reasonably believe that its obligation to pay is*

legal. As the Court of Appeal noted in *Aerojet, supra, 209 Cal. App. 3d at 228:* '[P]etitioners would be surprised indeed to learn that coverage depended upon whether the preceding employed to obtain recompense was defined as 'legal' or 'equitable' . . . It would come as an unexpected if not incomprehensible, shock to the insureds to discover that their insurance coverage was being denied because the plaintiff chose to frame his complaint in equity rather than in law.' Thus, as a matter of plain meaning the term 'legally obligated' covers injunctive relief and recovery of response costs. "Moreover even if this phrase raises doubts in the minds of legally trained observers about whether a law-equity distinction was needed, *it would be unreasonable to conclude that it unambiguously incorporates this sophisticated distinction into the policies.* In this respect whatever ambiguity it possesses in light of a party's legal knowledge is resolved in favor of coverage." (*Id.* at p. 825, emphasis added.)

Does not this same analysis apply to the *ex contractu-ex delicto* distinction? Even

a sophisticated policyholder would not anticipate that the term "legally obligated" precludes coverage for liabilities in contract. Because a court of law orders relief for both liabilities in contract and tort, policyholders naturally and reasonably believe that both are "legal obligations."

3. EVEN THE INSURANCE INDUSTRY UNDERSTANDS AND APPLIES THIS MEANING

Most tellingly, insurance industry publications readily acknowledge the pro-coverage interpretation.

The Associated General Counsel of Kemper Insurance Group, writing in a journal for insurance counsel, confirms the insurance companies' intent and expectation in this regard:

> "The coverage agreement embraces 'all sums which the insured shall become legally obligated to pay as damages . . . .'
> *That portion of the coverage grant is intentionally broad enough to include the insured's obligation to pay damages for breach of contract* as well as for tort within limitations imposed by other terms of the coverage agreement. (E.g., bodily injury and property damage as defined caused by an occurrence) and by the exclusions (e.g., this exclusion [(a)], CCC, alienated premises, damage to products, etc.)"

(Tinker, Comprehensive General Liability Insurance -

- Perspective and Overview (1975) 25 Fed'n Ins.

Couns. Q. 217, 265, emphasis added.)[5]

Writing in an insurance industry magazine for those holding the professional designation of Chartered Property and Casualty Underwriter ("CPCU"), a prominent underwriter unflinchingly states:

"[C]ommercial liability insurance policies are designed to protect against legal liability arising out of bodily injury or property damage, *regardless of whether the suit is in tort or contract."* (Hale, The Economic Loss Doctrine and the CGL: Confusing Disappointment with Disaster, in CPCU Journal, Sept. 1995, p. 185, 186, emphasis added.)[6]

Arthur L. Flitner, the Senior Director of Curriculum Design at the American Institute for Chartered Property Casualty Underwriters, the industry organization actually charged with training and certifying these underwriters, writing with another prominent

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[5]This article has been looked to for guidance by the California Courts in *Montrose Chemical Corp. v. Admiral Insurance Co. (1992) 35 Cal. App. 4th 335, 353; United Services Automobile Ass'n v. Cavanaugh (1991) 227 Cal. App. 3d 1277, 1287; Fireman's Fund Ins. Co. v. Aetna Casualty & Surety Co. (1990) 223 Cal. App. 3d 1621, 1629.* It was also relied upon by the secondary authority quoted in footnote 3 of the Court's March 26 opinion. See Franco, Insurance Coverage for Faulty Workmanship Claims Under Commercial General Liability Policies (1995) 3o Tort & Ins. L.J. 785, 788 n.13.

[6]The California Supreme Court looked to a very similar publication, the CPCU Annals, for guidance in *Montrose Chemical Corp. v. Admiral Ins. Co. (1995) 10 Cal. 4th 645, at 671.*

insurance industry CPCU and scholar in an insurance industry publication, explains the term "legally obligated" as follows:

> "The expression 'legally obligated' connotes legal responsibility that is broad in scope. It is directed at *civil* liability . . . [which] can arise from either unintentional (negligent) or intentional tort, under common law, statute, *or contract.*" (Malecki & Flitner, Commercial General Liability (6th ed. 1997) p. 6., emphasis added.)

Mr. Flitner's co-author, Donald S. Malecki,[7] in an article specifically focused on insurance companies often taking a contrary position when it serves their economic interests, readily admits:

> "The wording found in liability policies does not alert even the most sophisticated insurd to the potential elimination of coverage for injury or damage otherwise covere by the policy, but emanating from breach of contract." (Malecki, Breach of Contract:

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[7]Recent cases looking to Mr. Malecki's writing for guidance are *Ballow v. Phico Ins. Co.* (1993) 875 P.2d 1354, 1366, 1367; *Standard Fire Ins. Co. v. Chester-O'Donley & Associates, Inc.* (Tenn. App. 1998) 1998 Tenn. App. LEXIS 65, *16, *21, *23, *25; *Bailer v. Erie Ins. Exchange* (1997) 344 Md. 515, 533, 687 A.2d 1375; and *City of Edgerton v. General Cas. Co.* (Wis. App. 1992) 172 Wis. 2d 518, 533. He has been describedd by one court as "the father of many of the insurance policies' forms." *In re Dow Corning Corp.* (1996) 198 Bankr. 214, 232. Insurance companies use his analyses as authoritative. See, e.g., *Rivere v. Heroman* (La. App. 1997) 688 So.2d 1293, 1294, where Continental Casualty Co. cited Mr. Malecki's treatise, The Additional Insured Book.

Can It Be the Subject of Liability Coverage?, Malecki on Insurance, May 1995, p. 5, 7.)

Mr. Malecki explains:

> "From an analytical standpoint, the problem, in large part, stems from the fact that legal counsel for the insured is all too often willing to concede that coverage does not apply where the injury or damage (otherwise covered by the policy) emanates from a breach of contract. In fact, that premise should always be contested, properly briefed and reinforced with reference to the policy wording." (*Id.*, at p. 8.)

> "[This breach of contract vs. tort] doctrine is abused in large part, because lawyers are too timid in their challenge to the applicability under existing law." (Malecki, Breach of Contract as a Defense to Liability Coverage: One of the Most Abused and Misapplied Doctrines Today, in Malecki on Insurance, Nov. 1997, p. 7.)

Thus, members of the insurance industry itself, when they are speaking candidly amongst themselves, clearly recognize the "plain meaning" of "legally obligated" as encompassing liabilities in contract.

4. CONCLUSIONS REGARDING THE "PLAIN MEANING" RULE: "LEGALLY OBLIGATED" AND "LIABILITY IMPOSED BY LAW" DO NOT PRECLUDE COVERAGE FOR LIABILITIES IN CONTRACT, BUT OTHER POLICY PROVISIONS DO NARROW COVERAGE SIGNIFICANTLY

By any measure, the plain meaning of "legally obligated" and "liability imposed by law" includes liabilities in contract.

This is not to say that *all* liabilities in contract are covered by CGL policies. As indicated in the quotations from Windt, Zulkey, and Tinker above, the other qualifications in the insuring agreement (e.g., the "property damage" and "occurrence" qualifications), as well as the policy exclusions, eliminate many liabilities in contract from coverage under CGL policies. For example, a liability in contract for purely economic damages (which is to say a liability in contract which is *not* based upon any underlying "property damage") would not be covered.

This same analysis was recently stated in DiMugno, Personal Injury Coverage Does Not Apply to Breach of Insured's Implied Contractual Obligation to Obtain Regulatory Permits Necessary to Allow Claimant to Use Boat Dock (1997) 19 Ins. Lit. Rptr. 182: "Recognition that damages an insured is 'legally obligated' to pay includes contract as well as tort damages should not obligate insurers to cover most contractual breaches. Other qualifications in the insuring agreement, such as the requirement that the damages be for 'property damage' or 'bodily injury' and result from an 'occurrence' or 'accident' as well as the policy's exclusions, remove most contractual liabilities from

coverage under a comprehensive general liability policy."

That same analysis also appears in the body of Franco, Insurance Coverage for Faulty Workmanship Claims Under Commercial General Liability Policies (1995) 30 Tort & Ins. L. J. 785, quoted in footnote 3 of the Court's March 26 opinion. Note that Mr. Franco, an attorney for insurance companies, enumerates all the policy provisions negating coverage for business risks but passes over the "legally obligated" provision at the top of page 788 without discussion. This confirms the fact that the insurance industry's desire to avoid covering certain "business risks" is carried out by policy provisions *other* than the "legally obligated" qualification, such as by requiring that the liability be for "property damage."

Ironically, many of the coverage claims raised in the Devonshire line of cases, including *Devonshire* itself, should have failed for this reason. That is, the courts there reached the right result, but they went over-broad in stating the the reasoning behind their conclusion.

We acknowledge that insurance companies are free to completely and categorically preclude or exclude coverage for *all* liabilities in contract if they wish. All that is required is that they do so clearly and explicitly. (E.g., *Safeco Ins. Co. v. Andrews (9th Cir. 1990) 915 F.2d 500, 502).* However, this is not the case in Peck/Jones' policy or under the standard CGL forms.

We do not take a stand here as to whether Peck/Jones' liability to Center West is actually covered under its CGL policy. That requires an analysis of all the policy provisions other than the "imposed by law" provision (e.g., the "property damage"

requirement) and of facts not set forth in the Court's March 26 decision and not presently available to us.

B. INTERPRETING "LEGALLY OBLIGATED" UNDER THE "OBJECTIVE REASONABLE EXPECTATIONS OF THE INSURED" RULE: MANY POLICY PROVISIONS CLEARLY REFLECT COVERAGE FOR CERTAIN LIABILITIES IN CONTRACT

If a particular insurance provision is ambiguous under the "Plain Meaning" Rule, California courts then proceed to apply the second analysis, the "Objective Reasonable Expectations of the Insured" Rule, in attempting to resolve that ambiguity. Here, the context of the policy language is very important.

The Supreme Court has recently explained in this regard how policy meaning can be derived by a study of the structure of the CGL policy:

> "The policy is written in two essential parts: the insuring agreement, which states the risk or risks covered by the policy, and the exclusion clauses, which remove coverage *for risks that would otherwise fall within the insuring clause.* (*Waller v. Truck Ins. Exchange, supra, 11 Cal. 4th 1,* emphasis added.)

Thus, where exclusions remove certain risks from coverage and/or make exceptions from the ambit of those exclusions, it reveals that those very risks must have been covered under the insuring agreement. It is like a footprint in wet sand. Working

backwards, one can extrapolate from a study of the exclusions and their exceptions the nature of the risks covered by the insuring agreement. After all, there would be no need for the exclusion of a particular risk if that risk was already outside the scope of the insuring agreement. Similarly, an exception to an exclusion can only restore coverage for the particular risk described if that risk already fell within the scope of the insuring agreement. Therefore, the fact that exclusions exclude some liabilities in contract, and exceptions to exclusions return important liabilities in contract to coverage, provides conclusive evidence that liabilities in contract as a class are not precluded from coverage by the "legally obligated" requirement.

The CGL policy exclusions are replete with such evidence as to liabilities in contract. For example, the "your work" exclusion found in the post-1986 standard form policies reads as follows:

> "This insurance does not apply to . . . . 'property damage' to 'your work' arising out of it or any part of it and included in the 'products-completed operations hazard.'
>
> This exclusion does not apply if the damaged work or the work out of which the damage arises was performed on your behalf by a subcontractor."

Pursuant to the exception at the end of this exclusion, property damage to a policyholder's work remains covered if the damaged work or the work out of which the damage arises was performed by a subcontractor to the policyholder. (*Maryland Casualty*

Co. v. Reeder, supra, 221 Cal. App. 3d at 971-974; Insurance Company of North America v. National American Ins. Co. (1995) 37 Cal. App. 4th 195; Fireguard Sprinkler Systems v. Scottsdale Ins. Co. (9th Cir. 1988) 864 F.2d 648, 653-654). Of course, the policyholder's liability for such property damage is almost always a liability in contract. That is, true to their name "contractors" perform their work *under contract* with third parties. The standard CGL policies explicitly acknowledge that fact in the policy definition of covered "products-completed operations hazard" which provides that the policyholder's work will be deemed completed when "all of the work called for in your *contract* has been completed." An attorney who regularly represents insurance companies confirms: "This clause contemplates the activity of a policyholder that is a contractor -- *i.e.*, one who performs operations 'under [a] contract.'" Howard, Products/Completed Operations Coverage 1997: Still Learning Professor Henderson's Lessons 25 Years Later, in Coverage, Nov./Dec. 1997, p. 37.

Note in this regard that policyholder's pay an additional 20% in premiums for this completed operations coverage. (*Maryland Casualty Co. v. Reeder, supra, 221 Cal. App. 3d at 968.)* There would certainly be no point whatsoever in making the distinction reflected in the foregoing exception to the "your work" exclusion, or paying the additional 20% in premium for it, if the insuring agreement did not allow coverage for liabilities in contract in the first place.

There are numerous other instances in which the policy exclusions evidence coverage of liabilities in contract under the CGL insuring agreement. To name one more: Exclusion m. in the post-1986 standard form CGL policies excludes coverage for only

certain types of property damage which arise from the policyholder's "failure . . . to perform a contract or agreement," thereby indicating that *other* types of damage for failing to perform a contract would be covered.

Thus, taken *in its context* in the policy, it is quite clear that the term "legally obligated" includes liabilities in contract.

C. INTERPRETING "LEGALLY OBLIGATED" UNDER THE "CONTRA-INSURER" RULE

If the two foregoing rules of insurance policy interpretation do not resolve the ambiguity, i.e., the provision has no "plain and clear" meaning and the context does not reveal a single "objectively reasonable expectation" regarding the meaning, then the resultant ambiguity will simply be construed against the insurance company. Under this approach, the term "legally obligated" must be construed in the policyholders' favor.

Therefore, to defeat coverage an insurance company's interpretation of the provision must be *the only reasonable interpretation.* (*Stevens v. Fidelity & Casualty Co. (1962) 58 Cal.2d 862; Producers Dairy Co. v. Sentry Ins. Co. (1986) 41 Cal. 3d 903, 912.)* It simply cannot be said that the breach of contract vs. tort distinction is the only reasonable interpretation of "legally obligated."

III. THE DEVONSHIRE LINE OF CASES RUNS COMPLETELY CONTRARY TO THE LONG-ESTABLISHED BODY OF CALIFORNIA CASELAW UPHOLDING COVERAGE FOR LIABILITIES IN CONTRACT

California cases have traditionally upheld CGL coverage for liabilities in contract. The following discussion samples only a few of these decisions drawn from a single

commercial context, the construction industry.

In *Insurance Company of North America v. National American Ins. Co. (1995) 37 Cal. App. 4th 195* ,the policyholder was a roofing subcontractor on a condominium project. The roofs it built pursuant to its subcontract failed after completion, so it was sued by the homeowners' association and general contractor for the building. The policy would have contained the "legally obligated" qualification; yet, the court upheld coverage.

In *Economy Lumber Co. v. Insurance Co. of North America (1984) 157 Cal. App. 3d 641*, the policyholder was a lumber mill which had contracted to mill 90,000 board fee of lumber to certain contract specifications. Unfortunately, the lumber was mismilled and the policyholder was sued for the resultant damages. The policyholder's CGL policy contained the "legally obligated" qualification. Nevertheless, the court found in favor of coverage.

In *Maryland Casualty Co. v. Reeder, supra, 221 Cal. App. 3d 961*, a condominium homeowner association sued the condominium developer, general contractor, and pertinent subcontractors for property damage arising out of various construction defects. At least as to the general contractor and subcontractors, the obligations rose out of the performance of their contracts. Although its is not expressly revealed on the face of the opinion, the policy in question would have had either the "legally obligated" or the "liability imposed by law" qualification. Nevertheless, the court found that many of the claims against the policyholders were covered.

In *St. Paul Fire & Marine Ins. Co. v. Sears, Roebuck & Co. (9th Cir. 1979) 603 F.2d 780,* the policyholder had entered into an agreement with a homeowners' association

requiring it to install new roofing material over pre-existing roofs. The policyholder's work was defective and the homeowners' association sued. The policy contained the "legally obligated" qualification. Nevertheless, the Ninth Circuit, applying California law, upheld coverage.

In *Western Employees Ins. Co. v. Arciero & Sons, Inc. (1983) 146 Cal. App. 3d 1027,* the policyholder was a general contractor sued by a condominium homeowners' association for construction defects. The court denied coverage based on the application of the one of the policy exclusions. However, in doing so, it observed as follows:

> "The general contractor, of course, is free to pursue the subcontractors responsible for building the [defective] retaining wall and slope. Indeed, the record in this action shows that the contractor had cross-complained against the responsible subcontractors for indemnification. The subcontractors' work was merely a component part of the condominium project. *Thus, assuming the subcontractors had a similar liability policy, damage to the condominium units caused by the failure of the wall and the slope would . . . be covered."* (*Id,* at p. 1031, emphasis added.)

Of course, a subcontractor's liability to the general contractor would arise out of that subcontractor's contractual obligation to properly perform its work under the terms of the

subcontract. Nevertheless, the *Arciero* court understood the subcontractor in this situation to be "legally obligated" for that liability.

In *Central Mutual Ins. Co. v. Del Mar Beach Club Owners Ass'n (1981) 123 Cal. App. 3d 916,* the policyholder was the general contractor on a condominium development sued by its homeowners' association for construction defects. This must have been a liability in contract at least as to the insured general contractor. Although not expressly discussed, it is clear from the wording of the other policy provisions that the CGL form used to insure the general contractor would have had the "legally obligated" qualification. Nevertheless, the court upheld coverage.

In *Blackfield v. Underwriters at Lloyd's, London (1966) 245 Cal. App. 2d 271,* the policyholder was a builder and seller of homes sued by homeowners for construction defects. The builder's policy contained the "liability imposed by law" qualification. Nevertheless, the court upheld coverage for many of the items of property damage and sued upon.

None of the foregoing cases specifically addresses the "legally obligated" qualification (or its equivalent precursor, the "liability imposed by law" qualification). Nevertheless, these cases stand in mute testimony to the fact that the insurance companies in those cases did not believe that the "legally obligated" qualification barred coverage for the liabilities in contract involved there. If the term "legally obligated" had truly precluded coverage of these liabilities, why did these cases (and so many others) go so far without the insurance companies or the courts raising such a fundamental issue?

The point here is that the breach of contract vs. tort distinction is the recent

handiwork of insurance companies aggressively seeking to avoid paying for liabilities that the insurance industry has a whole has always intended to cover.

IV. HOW THE DEVONSHIRE LINE OF CASES REACHED THE WRONG INTERPRETATION OF "LEGALLY OBLIGATED"

The story begins with *Ritchie v. Anchor Casualty Co., supra, 135 Cal. App. 2d 245, ("Ritchie")*, where the court had before it a non-standard policy form that made an express distinction between "liability imposed by law" and "liability . . . imposed by written contract." Both items were used in the policy's insuring agreement for Coverage A of the policy, but the latter term was clearly and intentionally omitted from the insuring agreement for Coverage B, which was the only coverage part being applied to the damages in question. As a result, the *Ritchie* court held as follows:

> "The use of the phrase 'or by written contract' in A and its omission from B is persuasive that the phrase 'imposed upon him by law' as used in this policy and in the subject rider relates to the nature of the liability [tort or contract] to be defended . . . . And that is undoubtedly the correct connotation of the phrase in the policy at bar." (*Id.*, at 254).

International Surplus Lines Insurance Co. v. Devonshire Coverage Corp., supra, 93 Cal. App. 3d 601, ("Devonshire"), which followed 24 years later is the seminal case in the line of California cases relied upon in the court's March 26 decision. The policyholder there was an insurance agent who breached its agency contract with its

principal (a fire insurance company), by writing a fire insurance policy for a third party in excess of the agent's $500,000 line of authority with the principal. The agency agreement provided that the agent would indemnify the principal for any losses experienced as a result of writing insurance in excess of its authority. A fire ensured causing a loss considerably in excess of the $500,000 limit. The principal paid the loss in full but sued its agent for the amount in excess of $500,000. The agent tendered the principal's claim to his liability insurance company which had insured the agent for, among other things, liabilities of third parties "assumed" by the agent under a contract of indemnity. (That is, the agent had so-called "contractual liability coverage.") The *Devonshire* court first reasoned, quite correctly, that such assumed liabilities were only covered if they were covered under the other terms of the policy. That is, these liabilities are to be analyzed from the standpoint of the principal (the fire insurance company), as if the principal were insured under the policy. Pursuing this process, the court first considered whether or not the principal's liability was a "legal obligation." The court noted that the insurance company's liability was a liability in *contract,* as opposed to a liability in *tort.* The *Devonshire* court then looked to the *Ritchie* case and concluded, at 610, as follows:

> "The phrase 'legally obligated to pay as damages' as used in [Devonshire's liability insurance] policy, is synonymous with 'damages for liability imposed by law.' That latter phrase has been uniformly interpreted as referring to a liability arising ex delicto

> as distinguished from ex contractu. (*Ritchie v. Anchor Casualty Co., supra.*). The theory that Devonshire assumed a liability of [its principal] for which [Devonshire's liability insurance company] provided coverage cannot be sustained by the terms of the policy of applicable law."

In looking back to *Ritchie*, one finds the source of the *Devonshire* court's confusion. As discussed above, the policy in *Ritchie* had two different coverage parts, each part covering different liabilities and each having its own insuring agreement. Some of those insuring agreements covered both "liability imposed . . . by law" and "liability . . . by written contract," but the insuring agreement in question in *Ritchie* only covered "liability imposed . . . by law," thereby intentionally omitting coverage for "liability imposed . . . by written contract." Thus, the *Ritchie* policy, read as a whole, did put the policyholder on reasonable notice of both (1) the distinction being drawn between "liability imposed by law" and "liability imposed by contract" and (2) the fact that the insuring agreement being applied did not cover the latter. So, the rule in *Ritchie* made perfect sense within the context of the specific policy language before the court there.

The policy before the court in *Devonshire* did not offer separate coverage for, nor made any distinction between, "liability imposed by law" or "liability imposed by contract." Instead, it used a single term, "legally obligated," throughout the various insuring agreements found in that standard policy form. This new wording, unlike the earlier, non-standard version found in the *Ritchie* case, failed to put the policyholder on

notice that the policy did not cover liabilities in contract. In fact, as we have seen in II.,A,3 above, the insurance industry very much *intended* this insuring agreement to cover liabilities in contract.

Nevertheless, the *Devonshire* court somehow overlooked this enormous difference and mechanically followed the then-obsolete distinction made in the earlier *Ritchie* case without adequately studying and applying the new policy language before it. This violated the fundamental rule of policy construction that the words of the policy are used to determine the intent of the parties. A distinction made under another policy should not have been applied unless the wording of the new policy also justified it. However, that was not the case in *Devonshire*.

Insurance Companies and their attorneys were quick to seize upon the *Devonshire* court's mistake. They saw the potential of collecting billions of premium dollars to cover liabilities in contract, without ever having to pay for these accidents when they actually occurred. As a result, whatever its failings, the rule of *Devonshire* quickly spawned the progeny cited in the court's March 26 opinion: *Fireman's Fund vs. City of Turlock (1985) 170 Cal. App. 3d 988; Fragomeno v. Insurance Co. of the West (1989) 207 Cal. App. 3d 822; Loyola Marymount University v. Hartford Accident & Indemnity Co. (1990) 219 Cal. App. 3d 1217; Wilmington Liquid Bulk Terminals, Inc. v. Somerset Marine, Inc. (1997) 53 Cal. App. 4th 186.*

At the moment, this court stands poised to cooperate and accord the insurance industry an enormous, unearned windfall, at the expense of California policyholders.

CONCLUSION

United Policyholders, as *amicus curaie*, asks the court to modify its March 26 decision, so that it cannot be interpreted to mean that liabilities in contract can never covered under CGL policies.

The court should find that the terms "legally obligated" and "liability imposed by law" do not affect coverage for contract-based liabilities, but that other provisions in the CGL policy, e.g., the requirement that there be some form of "property damage," do significantly narrow coverage for these liabilities. However, this leaves many important liabilities in contract covered under the policy.

If the court's present holding stands unaltered, California's most fundamental rules of policy construction will have been successfully and egregiously violated by opportunistic insurance companies on the take for unearned, excess profits. Further, the court will be rewarding that very behavior with a multi-billion dollar windfall, paid at the expense of California businesses of all sizes, the thousands of claimants they accidentally injure every year, and the California economy in general.

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Dated: April 15, 1998

Respectfully submitted,

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PROOF OF SERVICE

STATE OF CALIFORNIA)
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COUNTY OF MONTEREY)

I, SUSANNE KREISER, declare and state:

I am employed in the County of Monterey, State of California, am over the age of 18 years and not a party to the within action. My business address is Post Office Box 1671, Carmel, California 93921.

On April 15, 1998, I served the foregoing document described as a ***Amicus Brief in Support of Petition for Rehearing***, on all parties in this action by placing a true copy thereof in a sealed envelope addressed as follows:

SEE ATTACHED SERVICE LIST

☐ **(By Facsimile)** I transmitted the document via facsimile transmission.

☒ **(By Mail Service)** I am "readily familiar" with the firm's practice of collection and processing correspondence for mailing. Under that practice it would be deposited with U.S. Postal Service on that same day with postage thereon fully prepaid at Carmel, California in the ordinary course of business. I am aware that on motion of the party served, service is presumed invalid if postal cancellation date or postage meter date is more than one day after date of deposit for mailing an affidavit.

☒ **(By Federal Express)** I am readily familiar with the business practice at my place of business for collection and processing of documents and correspondence for overnight delivery by Federal Express. Correspondence so collected and processed is deposited with Federal Express on the same day in the ordinary course of business. On the above date, the said envelope was collected for Federal Express Delivery following ordinary business practices.

☐ (By Personal Service) I delivered such envelope by hand to the offices of the addressee.

Executed on April 15, 1998 at Carmel, California.

☒ **(State)** I declare under penalty of perjury under the laws of the State of California that the above is true and correct.

☐ **(Federal)** I declare that I am employed in the office of a member of the bar of this court at whose direction the service was made.

/S/
Susanne Kreiser

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COUNTY OF MONTEREY)

I, SUSANNE KREISER, declare and state:

I am employed in the County of Monterey, State of California, am over the age of 18 years and not a party to the within action. My business address is Post Office Box 1671, Carmel, California 93921.

On April 16, 1998, I served the foregoing document described as a ***Appendix to Amicus Brief in Support of Petition for Rehearing***, on all parties in this action by placing a true copy thereof in a sealed envelope addressed as follows:

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Susanne Kreiser

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/S/
Susanne Kreiser

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