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NEWSLETTER

Discovery in Coverage Litigation Stayed Until Prejudice to Policyholder in Underlying Actions Can Be Determined

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In an unreported decision, the California Court of Appeal, applying California law, has granted a peremptory writ of mandate, directing a trial court to stay discovery sought by two excess insurers in coverage litigation until the trial court could determine whether the discovery would prejudice the policyholder in its underlying criminal and civil actions and, if so, whether a confidentiality order could protect the policyholder from such prejudice. *Advanced Marketing Svcs., Inc. v. Superior Court*, 2005 WL 3491023 (Cal. Ct. App. Dec. 21, 2005).

The policyholder, a public company providing distribution and publishing services for book publishers, purchased a one-year $5 million primary D&O liability policy and two $5 million excess liability policies from separate insurers. In 2003, the FBI and the SEC began investigating the company for alleged mail fraud, wire fraud and other criminal offenses. In addition, one of the company's employees was indicted for falsely inflating the company's earnings, which inflation resulted in a public announcement that the company's earnings would be restated. Numerous shareholder lawsuits followed.

The primary insurer acknowledged an obligation to reimburse the company for certain costs in defending the shareholder lawsuits, but denied coverage for costs of defending the criminal investigations. The company then initiated coverage litigation against the primary and excess carriers. The excess carriers, in turn, sought a declaration that they owed no duty to reimburse the company and later served deposition subpoenas and discovery requests on the company. The company objected to the discovery, arguing that participating in discovery in the coverage litigation would prejudice its defense of the underlying actions. The insurers moved to compel discovery. Relying on *Haskel, Inc. v. Superior Court*, 33 Cal. App. 4th 963 (1995), the company filed for a stay of discovery or, in the alternative, a protective order. The trial court granted the insurers' motion to compel, reasoning that *Haskel*, in which discovery propounded by primary insurers in coverage litigation was stayed, was inapplicable because the excess insurers were not primary insurers with a duty to defend the company and because the excess insurers alleged that their policies were void *ab initio* because of the company's alleged misrepresentations. The company filed a petition for a writ of mandate, asking the appellate court to vacate the trial court's order.

In issuing the writ of mandate, the appellate court first held that Haskel was not confined to instances where insurers owed their policyholders a duty to defend. According to the court, the three concerns expressed by the *Haskel* court in ordering the stay (permitting the insurer to "attack" its policyholder, with whom it has a "special relationship," forcing the policyholder to "fight a two-front war" with its insurer and the underlying claimants and creating collateral estoppel issues if the coverage litigation concluded before the underlying litigation) "exist[ed] irrespective of whether the coverage issue in question relates to the duty to defend or the duty to indemnify." The court further noted that there was an even more compelling basis to order the stay in this instance because the excess insurers did not "have the same urgent need to conduct discovery as . . . an insurer that has a duty to defend."

The court also rejected the insurers' contention that no "special relationship" ever existed because they were entitled to have the policies declared void *ab initio*. The court concluded that such a determination had not yet been made and that no law supported a contention that "a mere contention of fraud is sufficient to eliminate the existence of a special relationship or to automatically rescind an insurance policy." Accordingly, the court issued a writ of mandate directing the trial court to: (1) vacate its order compelling the company to comply with discovery, (2) determine whether all or part of the discovery was logically related to the issues of liability in the underlying proceedings, (3) determine whether a confidentiality order would be adequate to protect the policyholder with respect to the discovery and (4) stay all discovery until these issues could be determined.