Binding Effect of a Liability Judgment on Insurance Coverage

Introduction

A liability insurer may be bound by the outcome of a plaintiff's lawsuit against its policyholder depending upon whether the insurer fails to defend, faithfully defends, or defends under a reservation of rights. A liability insurer that wrongfully fails to defend is bound by a non-collusive judgment entered against its policyholder as to all issues necessarily adjudicated. A liability insurer that defends its policyholder is generally bound by the outcome of a plaintiff's lawsuit against its policyholder under the doctrine of collateral estoppel because the insurer is in privity with the policyholder and the requirements of due process of law are satisfied. A liability insurer that wrongfully fails to defend is generally bound by the outcome of a plaintiff's lawsuit against its policyholder.

Evidence developed during the pendency of a plaintiff's lawsuit may be used by the insurer against the policyholder to defeat coverage, but may not be used against the insurer to support coverage. This is not balanced and it may not seem fair, but it is the law.

A Defaulting Insurer Is Bound

A liability insurer that wrongfully fails to defend is generally bound by the outcome of the plaintiff's lawsuit. "If, after request, the [insurer] neglects to defend the [policyholder], a recovery against the [policyholder] suffered by him in good faith, is conclusive in his favor against the [insurer]."[1]

"An insurer that has been notified of an action and refuses to defend on the ground that the alleged claim is not within the policy coverage is bound by a judgment in the action, in the absence of fraud or collusion, as to all material findings of fact essential to the judgment of liability of the insured. The insurer is not bound, however, as to issues not necessarily adjudicated in the prior action and can still present any defenses not inconsistent with the judgment against the insured."[2]

A Performing Insurer Is Bound

A liability insurer that faithfully defends its policyholder is generally bound by the outcome of the plaintiff's lawsuit. The doctrine of collateral estoppel generally binds a performing insurer to the outcome of a plaintiff's lawsuit as to factual matters expressly or impliedly determined. "[A] party will be collaterally estopped from relitigating an issue only if (1) the issue decided in a prior adjudication is identical with that presented in the action in question; and (2) there was a final judgment on the merits; and (3) the party against whom the plea is asserted was a party or in privity with a party to the prior adjudication. (Citation.) This requirement of identity of parties or privity is a requirement of due process of law. . . . Thus, in deciding whether to apply collateral estoppel, the court must balance the rights of the party to be estopped against the need for applying collateral estoppel in the particular case, in order to promote judicial economy by minimizing repetitive litigation, to prevent inconsistent judgments which undermine the integrity

---

[1] Civil Code § 2778(5).

[2] *Geddes & Smith, Inc. v. St. Paul Mercury Indemnity Co.* (1959) 51 Cal.2d 558, 561-562; *Garamendi v. Golden Eagle Ins. Co.* (2004) 116 Cal.App.4th 694, 717-18.

of the judicial system, or to protect against vexatious litigation."[3] A survey of prior reported opinions hold "to the effect that the judgment in the underlying action is conclusive as to the insurer's liability hold only that if factual matters upon which the issue of coverage turns are expressly or impliedly determined in the prior action such determinations bind the insurer in the subsequent suit to enforce the provisions of the policy."[4]

A Reserving Insurer Is Not Bound

A liability insurer that reserves its right to later deny coverage is generally not bound by the outcome of the plaintiff's lawsuit, but is instead free to challenge coverage with a clean slate. "[C]ollateral estoppel 'is not an inflexible, universally applicable principle; policy considerations may limit its use where the . . . underpinnings of the doctrine are outweighed by other factors.'"[5]

In the landmark case of *Gray v. Zurich*, the California Supreme Court stated: "[T]he court in the third party suit does not adjudicate the issue of coverage . . . . The only question there litigated is the insured's liability. . . . [I]f the insurer adequately reserves its right to assert the noncoverage defense later, it will not be bound by the judgment. If the injured party prevails, that party or the insured will assert his claim against the insurer. At this time the insurer can raise the noncoverage defense previously reserved."[6]

The Policyholder May Not Use Favorable Factual Findings

"[R]es judicata does not merely bar relitigation of identical claims or causes of action. Instead, in its collateral estoppel aspect, the doctrine may also preclude a party to prior litigation from redisputing issues therein decided against him, even when those issues bear on different claims raised in a later case. Moreover, because the estoppel need not be mutual, it is not necessary that the earlier and later proceedings involve the identical parties or their privies. Only the party against whom the doctrine is invoked must be bound by the prior proceeding."[7] "Accordingly, we are compelled to conclude that a private arbitration award, even if judicially confirmed, can have no collateral estoppel effect in favor of third persons unless the arbitral parties agreed, in the particular case, that such a consequence should apply."[8]

Because a reserving insurer is not bound by factual conclusions, the policyholder may not use favorable factual conclusions against a reserving insurer. "[T]he insured may be collaterally estopped from relitigating any adverse factual findings in the third party action, notwithstanding that any fact found in the insured's favor could not be used to its advantage."[9]

An Intervening Insurer Is Not Bound by a Policyholder's Procedural Default

"An intervener is not limited by every procedural decision made by a party with which it is

---

[3] *Clemmer v. Hartford Ins. Co.* (1978) 22 Cal.3d 865, 874-75.

[4] *Hogan v. Midland National Ins. Co.* (1970) 3 Cal.3d 553, 565 (citations omitted).

[5] *Vandenberg v. Superior Court* (1999) 21 Cal.4th 815, 829 (*Vandenberg*).

[6] *Gray v. Zurich Insurance Co.* (1966) 65 Cal.2d 263, 279; reiterated with approval in *Blue Ridge Ins. Co. v. Jacobsen* (2001) 25 Cal.4th 489, 497-98.

[7] *Vandenberg, supra*, 21 Cal.4th at 828.

[8] *Vandenberg, supra*, 21 Cal.4th at 834.

[9] *Montrose Chem. Corp. of Calif. v. Superior Court* (1994) 25 Cal.App.4th 902, 910.

aligned. . . . A party permitted to intervene is permitted to do so in order to pursue its *own interests.* Once permitted to intervene, it is a party to the action not bound by other parties' procedural defaults. . . . [I]nsurers may intervene in third party actions brought against their insureds in order to protect their own interests when their insureds are unable to defend. . . . [T]he intervening insurers are then entitled to litigate liability and damages issues that their insureds are barred from litigating. . . . Indeed, there would be no purpose in allowing an insurer to intervene in order to protect its *own* interests but then limit the scope of the insurer's defense to those issues to which *its insured,* because of the default, is limited to pursuing."[10]

Development of Evidence

During the pendency of a plaintiff's lawsuit, the plaintiff and the policyholder shape factual and legal issues to be resolved and give sworn evidence in the forms of trial testimony, deposition testimony, declarations under penalty of perjury, responses to requests for admission, responses to interrogatories, and document productions. All of these materials may or may not be detrimental to the interests of the policyholder in a coverage dispute with the insurer. In contrast, neither the insurer nor its lawyers usually give any testimony that may be detrimental to the insurer's coverage position.

"When the liability, obligation, or duty of a third person is in issue in a civil action, evidence of a final judgment against that person is not made inadmissible by the hearsay rule when offered to prove such liability, obligation, or duty."[11] A judge or jury may ascertain the credibility of a witness based upon a "statement previously made by him that is inconsistent with any party of his testimony at the hearing."[12] "Evidence of a statement . . . that is inconsistent with a statement by [a witness] . . . is not inadmissible for the purpose of attacking the credibility of the [witness]."[13] Evidence of a statement made by a witness is admissible "if the statement is inconsistent with his testimony at the hearing",[14] or if the "party against whom the former testimony is offered was a party to [a former] action"[15] or the "party to the [civil] action . . . in which the former testimony was given had the right and opportunity to cross-examine the declarant with an interest and motive similar to that which the party against whom the testimony is offered has at the hearing."[16]

Because evidence developed during the defense of the plaintiff's lawsuit may be admissible in a subsequent coverage action, policyholders and plaintiffs often should consider the consequence of such evidence upon the coverage dispute.

---

[10] *Western Heritage Ins. Co. v. Superior Court* (2011) 199 Cal.App.4th 1196, 2007-08.

[11] Evid. Code § 1302.

[12] Evid. Code § 780.

[13] Evid. Code § 1202.

[14] Evid. Code § 1235.

[15] Evid. Code § 1291.

[16] Evid. Code § 1292.