Justices May Hesitate to Review Calif. Fraud Coverage Case

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January 6 2022

Many states have statutes or public policy that prohibits insurers from indemnifying policyholders for claims caused by their own willful acts. This is typical in the context of criminal acts or punitive damages, which many jurisdictions consider uninsurable. Likewise, statutory consumer protection claims are often uninsurable. Many court decisions also say that insurers have no duty to defend actions involving claims caused by an insured's willful acts.

But a statute in California goes a step further – it prohibits insurers from defending insureds in certain consumer protection claims brought by the state. A policyholder recently challenged the constitutionality of this provision. The issue may soon be decided by the Supreme Court. A petition for a writ of certiorari will be conferenced by the Supreme Court on January 14, 2022. The case is *Adir International, LLC v. Starr Indemnity*, 21-537.

In *Adir International*, the policyholders argued that a California statute violated their due process rights to counsel in civil cases by impinging on their ability to fund a defense of these claims. Earlier this year, the Ninth Circuit Court of Appeals ruled against the policyholders. The policyholders recently asked the Supreme Court to take up the case.

Background

Adir International LLC and its CEO, Ron Azarkman, operated a chain of stores in California called Curacao that sells "basic big-ticket household necessities" to a predominantly low-income Spanish-speaking immigrants. In 2017, then-California Attorney General Xavier Becerra filed a civil complaint accusing Adir and Azarkman of engaging in unfair debt collection practices and misleading advertising. Adir's insurer, Starr Indemnity and Liability

Company, which issued a $10 million directors and officers policy to the retail operators, agreed to defend them against the allegations under a reservation of rights. However, when the California Attorney General informed Starr that it was in violation of Section 533.5, Starr withdrew the defense. Adir and Azarkman then filed a lawsuit against Starr alleging that California Insurance Law Section 533.5 unconstitutionally deprived them of their right to counsel.

Section 533.5, enacted over 30 years ago, prohibits insurance companies from providing a defense for policyholders accused of violating the state's Unfair Competition Law and False Advertising Law. Although Section 533.5 prohibits insurers from covering any fines or fees arising from criminal actions or lawsuits brought by state or local authorities pursuant to California's consumer protection statutes, insurers may still cover civil damages arising from such claims.

Both a federal district court and the Ninth Circuit Court of Appeals sided with Starr. In *Adir Int'l, LLC v. Starr Indem. & Liab. Co.,* 994 F.3d 1032 (9th Cir. 2021), the Ninth Circuit held that the due process right to civil counsel is more "limited" than the Sixth Amendment right to counsel for criminal defendants. The Court held that due process only "bars the government from actively preventing a party from obtaining counsel or communicating with his or her lawyer in civil cases." The court held that Section 533.5 does not violate this due process right to civil counsel. The court stated that Section 533.5 only prohibits one source of funding to retain civil counsel, but "d[id] not actively prevent [a civil party] from obtaining counsel or communicating with its lawyers." The court held that, at most, Section 533.5 interfered with an indirect right to fund and retain counsel through an insurance contract, but that the due process right to civil counsel did not include this asserted right.

The policyholders recently sought leave to appeal to the U.S. Supreme Court.

The policyholders argue that Section 533.5 undermines their due process rights by preventing them from funding the defense of consumer protection claims. The policyholders also point to the importance of D&O insurance to corporate governance, without which many capable individuals would be reluctant to serve on corporate boards.

The petition for a writ of certiorari is supported by an array of prominent business and libertarian groups like the New Civil Liberties Alliance and the Cato Institute. These groups

argue that Section 533.5 poses a unique threat to small and mid-sized businesses who lack the resources of the government in defending themselves against what is potentially bet-the-company or career-ending litigation.

The policyholders also argue that the statute is particularly troubling because California is tipping the scales in only those consumer protection cases where a California governmental entity is itself an interested party. The history of Section 533.5 showed that the California Attorney General found it difficult to settle these consumer protection suits when defendants were using insurance to help defend themselves. With the benefit of insurance, defendants were more likely to litigate than to accede to the State's settlement demands. Stripped of insurance, defendants targeted by the State face immense financial pressure to settle.

Notably, insurers in California remain free to cover consumer protection claims brought by private parties. According to the policyholders, this discrepancy underscores the State's self-interested motivation in enacting Section 533.5. The policyholders argued that 533.5 runs contrary to cases holding that a state cannot stack the deck in its favor in litigation.

Starr has argued that the courts should defer to each state's broad authority to regulate insurance. Starr also argued that the policyholders are seeking to expand the limited right to civil counsel beyond that recognized in Supreme Court precedent.

Supreme Court Intervention?

Whether the Supreme Court intervenes is an opening question.

The Supreme Court may not grant certiorari because there is no split of authority in the circuit courts. In addition, the case presents a facial, rather than "as applied," challenge to the law. In other words, the policyholders did not argue that it could not afford competent counsel. Rather, they argued that the law was unconstitutional in all cases. Therefore, the Supreme Court may be disinclined to intervene in a case which requires it to render a broad ruling that cannot be limited to the case's facts.

On the other hand, a facial challenge presents a clean record with no factual disputes. In addition, as the policyholders argued, because the California law is one-of-a-kind, a circuit split will never occur. The policyholders also emphasized that the Court's guidance is important to businesses and executives operating in California that are targeted by the State.

They also argued that the statute requires no hearing or showing of probable cause before stripping insurance funding and thus goes to the heart of their due process rights.

The case presents an interesting question of the extent to which state regulators can prohibit even the defense of unproven, willful conduct and whether doing so impinges on a policyholder's constitutional right to counsel. Even if the Supreme Court does not intervene, the Ninth Circuit decision may be used as precedent for other states to enact their own restrictions on the ability of businesses to obtain insurance of defense costs in the private marketplace.