wiley

NEWSLETTER

Court Affirms Arbitration Holding that Defense Costs Outside Policy Limits

June 2010

The United States District Court for the Southern District of California, applying California law, has affirmed an arbitration ruling that defense costs paid by an insurer on behalf of an insured under a business management and indemnity policy did not erode the policy's $1 million limit of liability. *Illinois Union Ins. Co. v. N. County OB-GYN Med. Group, Inc.*, 2010 WL 2011522 (S.D. Cal. May 19, 2010). The court held that the arbitration panel correctly determined that, at a minimum, the policy's use of the term "incurred by" the insureds in defining amounts that would erode the limit of liability was ambiguous.

The insured sought coverage under the policy's employment practices liability (EPL) section for suits filed against it by a former employee. The EPL section provided that it was the duty of the insurer to defend any claim under that section. The insurer provided a defense, hiring a law firm to represent the insured and paying the firm's bills. Once defense costs had eroded the policy's $1 million limit of liability, the insurer informed the insured that coverage had been exhausted and that it no longer owed a duty to defend. The insured disagreed, arguing that defense costs paid by the insurer pursuant to its duty to defend did not erode the policy's limit of liability because they were not "incurred by" any insured.

The insurer relied upon three provisions of the policy, which stated that the "limits of liability available to pay insured loss shall be reduced by amounts incurred for costs, charges and expenses," that "Payments of Loss by Insurer shall reduce the Limits(s) of Liability" and that "Costs, Charges and Expenses are part of, and not in addition to, the Limits(s) of Liability and payment [of them] reduces the Limit(s) of Liability." The policy defined "Loss" to include "damages, judgments, settlements ... and Costs, Charges and Expenses incurred by any of the Insureds." The policy defined "Costs, Charges and Expenses" to include "reasonable and necessary legal costs, charges, fees and expenses incurred by any of the Insureds in defending Claims." The arbitration panel held that the policy was at least ambiguous as to whether defense costs eroded the $1 million policy limit and, therefore, that the insured was entitled to unlimited coverage for defense costs.

The district court, applying the Federal Arbitration Act's deferential standard of review, affirmed the arbitration award. Although the court acknowledged that the insurer's position was "the more straightforward" one, it held that the arbitration panel's finding of ambiguity—based on the insured's contention that defense costs were not "incurred by any of the Insureds"—was plausible. The policyholder argued that it did not "incur" the fees paid to the law firm by the insurer because the insurer—and not the insured—was obligated under the

policy to provide a defense. In addition, the insured noted, the firm sent its bills directly to the insurer, which in turn paid them. The court agreed that the relevant policy provisions did not "speak for themselves" but, instead, were "susceptible to conflicting interpretations." The court distinguished opinions cited by the insurer because the policies in those cases either did not impose a duty to defend or did not use the term "incurred by" the insureds in defining defense costs that would erode the policy limit.

In short, the court held, the policy language represented "a classic case of an ambiguity that can reasonably be resolved in either party's favor" and affirmed the arbitration panel's ruling in favor of the insured.