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NEWSLETTER

Underlying Insurance Not Exhausted by Insured's Out-of-Pocket Payment of Defense Costs

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The Supreme Court of Delaware, applying California law, has held that an insured's own payment of defense costs does not count toward exhaustion for purposes of triggering an excess insurer's defense obligations. *Intel Corp. v. Am. Guarantee & Liab. Ins. Co.*, Case No. 692, 2011 (Del. Sept. 7, 2012).

The insurer issued a "following form" excess policy to the insured, which sat above $55 million in underlying coverage. While the excess policy included a provision specifying that the excess insurer will not have any duty to defend a claim against the insured, an endorsement to the excess policy provided that "[a]ll preprinted terms and conditions of [excess policy] are deleted to the extent that they are inconsistent with the terms and conditions of the [underlying insurance]." The underlying policy contained a duty to defend. The endorsement further provided that "[n]othing contained in this Endorsement shall obligate us to provide a duty to defend any claim or suit before the Underlying Insurance Limits . . . are exhausted by payment of judgments or settlements."

The insured was named as a defendant in several antitrust suits for which it sought coverage for the "significantly more than $50 million in defense costs [that] it paid out-of-pocket." The insured reached a settlement with one of the underlying insurers pursuant to which the underlying insurer paid $27.5 million of its $50 million policy limits. Subsequently, the insured turned to the excess insurer for reimbursement of its defense costs above $50 million. The excess insurer refused to provide coverage on the grounds that it had no defense obligation because the underlying policy limits were not exhausted "by payment of judgments or settlements." The insured contended that the endorsement to the excess policy created a defense obligation that must be read in conjunction with a condition of the excess policy, which stated that "[c]overage under this policy will not apply unless and until the insured or the insured's underlying insurance has paid or is obligated to pay the full amount of the Underlying Limits of Insurance." According to the insured, the condition's reference to "[c]overage under this policy" incorporated both a defense and indemnity obligation, such that the insured's payment of defense costs operated to exhaust the underlying policy limits and trigger the excess policy.

The court held that the excess insurer's defense obligations were not triggered, concluding that the scope and application of the excess insurer's defense obligation was limited by the endorsement requiring that the underlying limits be "exhausted by payments of judgments or settlements" before its policy responds. According to the court, the phrase "payments of judgments or settlements" in the endorsement cannot be construed under California law to encompass an insured's own payment of defense costs. Citing *Qualcomm, Inc. v. Certain Underwriters at Lloyd's, London*, 73 Cal. Rptr. 3d 770 (Ct. App. 2008), the court held that "[p]lain policy language on exhaustion . . . will control despite competing public policy concerns." The court noted the complex interplay between the policy language and the language of the endorsement, but concluded that "[a] complicated policy does not mean, however, that there is no single reasonable interpretation of its language, or that every proffered interpretation will be a reasonable one." In so holding, the court rejected the insured's argument that the language of the endorsement modified the condition's definition of coverage to incorporate a defense obligation. According to the court, the insured's interpretation created an irreconcilable conflict between the condition and the exhaustion language in the endorsement. The court concluded that the insured's interpretation "would read out [the exhaustion provision], violating the basic rule of construction that no part of an agreement should be rendered superfluous." The court also rejected the insured's contention that the policy language rendered the excess insurer's defense obligation illusory, concluding that "it would be reasonable to expect that, in most circumstances, the [excess policy] would be triggered for indemnity payments and not defense costs."