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An Insurer That Breaches Its Obligation to *Reimburse* Its Insured for Defense Fees and Costs May Be Precluded from Relitigating the Issues of Liability and Damages in the Underlying Action

Amy Briggs and Nicholas Wenbourne

Executive Risk Indemnity, Inc. ("Executive Risk") issued a professional liability policy to Stars Holding Company, Inc. ("Stars"). In the policy, Executive Risk expressly disclaimed a duty to defend. Instead, Executive Risk was required to reimburse its insured for defense fees and costs subject to a \$250,000 retention and a \$10 million limit of liability. The matter of apparent first impression was whether Executive Risk's breach of its duty to *reimburse* its insured for attorney's fees and costs bound the carrier on the issues of (1) the insured's liability and (2) damages. The California Court of Appeal, First Appellate District, has answered the question affirmatively.

Reese Jones ("Jones"), Stars' customer, brought an arbitration proceeding to recover damages caused by Stars' financial services and advice. Stars tendered Jones' arbitration demand to Executive Risk, and stated several times that it was insolvent and unable to mount its own defense. Executive Risk maintained that absent payment of the retention, which Stars could not pay, it had no obligation to reimburse Stars' attorney's fees and costs.

In light of the standstill between Executive Risk and Stars, Jones proceeded to an uncontested arbitration hearing, which resulted in a confirmed award of \$22 million, plus interest. Executive Risk then sued Jones, to whom Stars had assigned its claim for indemnity under the policy, for declaratory relief.

The trial court permitted Executive Risk to reopen the issue of Stars' liability and the damages sustained by Jones. In doing so, the trial court found that the arbitration award had no

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collateral estoppel effect because Executive Risk had not been a party to the arbitration proceeding.

The Court of Appeal, however, disagreed as to the preclusive effect of the arbitration. Reversing the trial court, the appellate court held that Executive Risk's decision not to participate in the arbitration precluded it from now contesting the issues of liability and damages. "Because [Executive Risk] had notice of the underlying action against its insured as well as the right to participate in the underlying proceeding, it is precluded from relitigating the award and judgment entered against its insured in this coverage action." Executive Risk's recourse, the court noted, would have been to intervene in the underlying proceeding to protect its own interests.

Accordingly, having issued an indemnity-only policy, an insurer with notice of a pending action in which it has the right to participate and does not act at its peril.

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