

Insured's Breach of Contract Claim, But Not Bad Faith Claim, Subject to Arbitration

February 2011

A federal district court has held that, under California law, a company's breach of contract claim against its insurer, which had issued the company an employment practices liability policy, fell within the scope of the policy's arbitration clause, while the company's claim for breach of the covenant of good faith and fair dealing fell outside the scope of the clause. *AG La Mesa LLC v. Lexington Ins. Co.*, 2011 WL 11504 (S.D. Cal. Jan. 3, 2011).

A former employee of the company filed suit alleging employment-related violations. The company notified its insurer of the suit, and the insurer denied coverage. The company requested that the insurer reconsider its position, and the insurer affirmed the denial without mentioning the policy's arbitration clause. After the company filed an action against the insurer, the insurer invoked the policy's arbitration clause. When the company refused to submit to arbitration, the insurer filed a motion to compel arbitration.

The court first observed that the policy's arbitration clause mandated binding arbitration of a "disagreement as to the interpretation of this policy." The company had asserted two causes of action against the insurer—one for breach of contract and the other for breach of the covenant of good faith and fair dealing. With regard to the breach of contract claim, the court acknowledged that public policy favored arbitration and indicated that, when construing an arbitration clause, it would resolve doubts in favor of arbitration. In this regard, the court rejected the company's effort to distinguish policy "interpretation" from the exercise of weighing the evidence regarding the parties' conduct to decide whether the insurer had breached its obligations under the policy. In the court's view, the term "interpretation" encompasses both activities, and the court therefore held the breach of contract cause of action fell within the scope of the arbitration clause. Turning to the breach of the covenant of good faith claim, the court acknowledged that it was entirely dependent on the breach of contract claim. Nevertheless, the court held that it did not fall within the scope of the arbitration clause because the covenant of good faith and fair dealing, by definition, concerned an insurer's obligations outside the express terms of the insurance contract.

The court next considered the company's arguments that the insurer had waived or was estopped from relying on the arbitration clause because it had waited to invoke it until after the company filed the coverage action. Noting that waiver required clear and convincing evidence of the insurer's subjective intent to mislead the policyholder, the court concluded the insurer had not waived the clause by waiting to inform the company it

intended to invoke the provision, particularly because the parties had specifically negotiated the wording of the arbitration clause. The court also concluded that the insurer was not estopped despite a six-month delay in invoking the clause because the company had specific knowledge of the arbitration clause based on the pre-inception negotiations. Therefore, the court ordered the parties to submit the breach of contract claim to binding arbitration and stayed litigation of the breach of the covenant of good faith claim pending the outcome of the arbitration.