

ALLOCATING COVERAGE AMONG COVERED AND NONCOVERED CLAIMS

AN UPDATE ON THE DUTY TO DEFEND

By William E. McGrath Jr.

With the increasing complexity of civil litigation, a corresponding likelihood exists that insurers will face claims and complaints against policyholders that present both covered and noncovered claims. In assessing how to best proceed, policyholders and insurers must address various issues, including whether to defend at the outset or to later address an obligation to reimburse, how to apportion expenses, who will control and direct the defense, and how to navigate the conflicts that may arise between the insurer and policyholder.

Uniform procedures for the treatment of claims cannot be established because of the wide variance in types of claims, underlying facts, and policy terms. State law, which varies widely, will typically control the scope of the insurer's defense obligation. Providing a 50-state survey on the duty to defend is not the intent of this article. Rather, I seek to raise issues recently discussed in national case law that policyholders and insurers should likely consider when

assessing the treatment and defense of claims and complaints.

The new century has seen a proliferation of pharmaceutical products claims, continued growth of shareholder litigation, and myriad intellectual property disputes. These claims invariably result in submissions to and demands upon insurers to defend or pay for their defense. Thus coverage counsel for both policyholders and insurers are involved at increasingly earlier stages, and the cooperative atmosphere—to the extent it once existed—seems little more than a quaint memory.

The Duty to Defend: The Basics

An insurer's duty is, from an aerial perspective, no different now than in the past. State law typically requires an insurer to juxtapose the complaint and policy, and if the allegations arguably come within the covenant to indemnify, the insurer must defend. But complaints frequently contain disparate claims, some of which clearly trigger a defense obligation while others do not. For example, a professional negligence complaint against a lawyer or accountant will

certainly contain garden variety malpractice claims, but it may also include allegations sounding in fraud or conspiracy. A governmental action or qui tam complaint may raise allegations under the Racketeer Influenced and Corrupt Organizations Act or the False Claims Act in addition to the standard negligence claims.

An insurer can analyze such claims in a number of ways. It may delineate which claims or counts, standing on their own, would trigger a duty to defend. Indeed, this step is always necessary for preparing a reservation of rights letter. Critically analyzing the core set of facts is the starting point. Does the conduct at issue form the basis for both negligence and intentional (or reckless, criminal, or conspiratorial) claims? Or do the covered and noncovered claims arise from separate and independent conduct? Many courts have held that when noncovered claims are "intertwined" with claims that are covered, the insurer's duty to defend extends to both.¹

If we assume a hypothetical complaint against a single insured that contains five counts, three of which

must be defended and two of which, standing alone, would not, how can or should the insurer respond? The overly simplistic response may be to retain the insurer's defense counsel of choice and offer to fully fund the cost of defense. Or the insurer may retain counsel to defend the three covered claims and suggest that the policyholder hire its own counsel for the others.

Sophisticated insureds often object to the insurer's selection of counsel and to the insurer's control of the defense. Indeed, a policyholder may object to the insurer doing anything other than paying the bills. The insurer may do well to consider whether counsel selected by the insured, or perhaps independent counsel previously used by neither carrier nor insured, with an agreement on both hourly rate and an allocation of responsibility, might be the safest route. Too frequently, the insurer's retention of its preferred counsel (whether paying all or a portion of the costs) will result in later claims of bad faith, perhaps for failing to settle or settling wrongfully.

If our hypothetical five-count complaint were filed in New Jersey, the insurer might consider it best not to defend its insured. Upon conclusion of the litigation, if the insured's ultimate liability was predicated upon covered acts, the

insurer's erstwhile duty to defend would be transformed into an obligation to reimburse.² This so-called *Burd* doctrine, something of an anomaly in the otherwise policyholder-friendly confines of New Jersey, was fashioned in a case where the New Jersey Supreme Court concluded that the insurer's control of the defense might prejudice the insured in an ongoing coverage dispute or where the underlying litigation would likely leave open the question of coverage.³

In contrast, if the complaint were filed in Arizona or Massachusetts, the insurer would likely have a duty to defend the entire case until such time as no claims were pending that could potentially trigger a duty to indemnify.⁴ Regardless of jurisdiction, and with an eye on choice of law issues, applicable state law typically informs this initial analysis of the qualitative nature of the duty to defend.

Seeking Reimbursement of Defense Costs

Many insurer/insured disputes arise in the murkier context of an insurer seeking reimbursement of all or a portion of defense costs already paid on its insured's behalf. Courts in Florida, Montana, New York, Connecticut, and New Jersey have recently recognized such a reimbursement claim by insurers.

In *Wendy's of N.E. Florida, Inc. v. Vandergriff*,⁵ the court stated that an insurer may seek allocation and reimbursement of that portion of defense expenses attributable to noncovered claims but only if the insurer timely defended, appropriately and specifically reserved its rights, and secured the policyholder's agreement to the reservation.⁶

The Montana Supreme Court considered the reimbursement

question in *Travelers Casualty & Surety Co. v. Ribl Immunochem Research*.⁷ There, the insurer asserted a claim for the return of defense costs paid in light of a finding that the pollution exclusion defeated both defense and indemnity obligations. Agreeing with the insurer's position, the court reasoned:

We likewise conclude the District Court properly determined that [the insurer] may recoup its defense costs expended on [the insured's] behalf for those claims outside the CGL policy's pollution exclusion provision. [The insurer] timely and explicitly reserved its right to recoup defense costs when it notified [the insured] of the reservation prior to the payment of the defense costs in various letters. [The insurer] expressly reserved its right to recoup defense costs if a court determined that it had no duty to provide such costs . . . and . . . [the insured] implicitly accepted [the insurer's] defense under a reservation of rights when it posed no objections.⁸

In *Federal Insurance Co. v. Kozlowski*,⁹ the court addressed an insurer's obligation to defend Tyco International's former chairman, Dennis Kozlowski, in a civil action alleging that he had breached his fiduciary duties under the Employee Retirement Income Security Act of 1974 (ERISA), as well as in separate civil securities and criminal actions. In the ensuing coverage litigation, the insurer sought to rescind its 2001–2003 renewal policy for material misrepresentations, which included, among other things, statements made in Tyco's 10-K statements. In its declaratory

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judgment complaint, the insurer sought the court's imprimatur to terminate its ongoing defense and to recover previously expended costs. On cross-motions, the trial court held that, unless and until the rescission claim was finally resolved in the insurer's favor, it would have a continuing duty to defend.

On appeal, the court observed that no allocation between covered and noncovered claims could be made as the litigation proceeded. In that circumstance, the insurer was obliged to continue to defend all claims, covered and not, until such time it was determined that certain claims fell within exclusions or were otherwise outside the coverage.¹⁰

The Connecticut Supreme Court considered the issue in *Security Insurance Co. of Hartford v. Lumbermens Mutual Casualty Co.*¹¹ in the context of one defending insurer seeking contribution from another insurer that had declined to defend. Relying on *Insurance Co. of North America v. Forty-Eight Insulations, Inc.*¹² and *Buss v. Superior Court*,¹³ the court recognized an insurer's right to recoup expenses allocated to uncovered claims. The basis was relatively simple: to not allow such a claim would constitute a windfall to the insured.¹⁴

Many years after *Burd v. Sussex Mutual Insurance Co.*,¹⁵ the New Jersey Appellate Division addressed an insurer's duty to defend a complaint that asserted conflicting alternative theories of liability, one intentional (assault and battery) and one negligent (negligent hiring), in *L.C.S., Inc. t/a D'Jais Bar, Inc. v. Lexington Insurance Co.*¹⁶ The carrier disclaimed, declining to defend any aspects of the complaint, since the claims arose from an alleged intentional assault. The

case was ultimately settled, and the insured brought an action to recoup the cost of defense and the \$25,000 settlement. (Predictably, the release reflected that only the negligence claim was settled; all other claims were dismissed.) The court found the negligence claims to have clearly triggered a duty to defend and affirmed the trial court's admittedly unscientific award of 50 percent of defense costs and the \$25,000 settlement.¹⁷ Surprisingly, however, the court did not hold that the insurer's wrongful refusal to defend the covered claims precluded apportionment of defense costs after the fact.¹⁸ Relying on the New Jersey Supreme Court decision in *SL Industries, Inc. v. American Motorist Co.*,¹⁹ the appellate division also declined to follow the principle that, if defense costs were not readily capable of apportionment, the insurer would have the obligation to reimburse all fees and costs.²⁰

In *SL Industries*, the New Jersey Supreme Court explicitly held that the fact that defense costs are not readily capable of apportionment is not a bar to an insurer's claim for reimbursement, even if the insurer improperly refused to defend a case involving covered and noncovered claims.²¹ In reaching its holding, the court did adopt the general rule that when an insurer wrongfully refuses to defend an action and is later required to reimburse defense costs, the insurer's reimbursement obligation is limited to covered claims, assuming apportionment of covered and noncovered claims can be achieved.²² Moving beyond the general rule followed by many jurisdictions, the court went on to state:

[W]e note that our interpretation differs from that of a num-

ber of courts that have applied it. Those courts presume that apportioning the costs will be very difficult and thus the exception, requiring insurers to pay all of the defense costs if they are not capable of apportionment, thus applies more often than the rule requiring apportionment We recognize that insurers, insureds and courts will rarely be able to determine the allocation of defense costs with scientific certainty. However, the lack of scientific certainty does not justify imposing all of the costs on the insurer by default. . . . We presume that the insurer and the insured can negotiate a satisfactory settlement that fairly apportions the defense costs. When they are unable to agree, we likewise presume that our courts will be able to analyze the allegations in the complaint in light of the coverage of the policy to arrive at a fair division of costs.²³

This somewhat anomalous—at least for New Jersey—line of cases was continued in *Hebela v. Healthcare Insurance Co.*²⁴ In that action, the appellate division viewed the trial court's efforts to apportion the legal fees as little more than "a cursory effort" and remanded in light of *SL Industries* for a "fair and reasonable estimate" if not "scientific precision."²⁵

Other courts have taken a contrary view of the reimbursement or recovery of defense costs attributable to noncovered claims. Notably, the Fourth Circuit considered the issue in *Perdue Farms, Inc. v. Travelers Casualty & Surety Co. of America*.²⁶ The plaintiffs were defendants in a class action

alleging various ERISA and wage and hour violations. Under a reservation of rights, Travelers defended the entire complaint under a fiduciary responsibility policy that did not provide coverage for the wage and hour claims. Travelers later declined to fund the \$10 million settlement reached in the underlying action, contending that the bulk of that amount was attributed to the plaintiffs with both ERISA (covered) and wage and hour (uncovered) claims.

Perdue subsequently sought recovery of the settlement amount, while Travelers claimed a portion of \$4.4 million in defense costs. Applying Maryland law, the court noted the absence of any authority that would allow an insurer to recover costs expended in the defense of uncovered claims, so long as claims were asserted that did trigger a duty to defend. Unlike the Connecticut Supreme Court in *Security Insurance*, which viewed the defense of uncovered claims as a windfall for the insured, the Fourth Circuit in *Perdue Farms* viewed the prospect of recouping certain noncovered defense costs as a “backdoor narrowing of the duty to defend.”²⁷ While declining to apportion defense costs, the court did apportion the settlement amount among covered and noncovered claims, requiring indemnification of those amounts attributable to the ERISA claims and remanding for allocation of settlement monies paid for “mixed” claims.²⁸

The Wyoming Supreme Court also weighed in on the issue in *Shoshone First Bank v. Pacific Employers Insurance Co.*²⁹ In that case, the court considered a question certified to it by the U.S. District Court for the District of Wyoming:

Does Wyoming law recognize a legal or equitable right of insurer allocation, allowing the insurer to allocate to its insured and recover either (1) the costs of defending non-covered claims, where there is at least one covered claim and the insurer has already paid for the defense, or (2) the costs of bringing a counterclaim, where there is at least one covered claim and the insurer has already paid for the litigation of the counterclaim?³⁰

The district court action involved a suit against the insured bank by a former director, alleging wrongful termination, invasion of privacy, and a host of other claims. In light of a single covered claim (invasion of privacy), Pacific agreed to defend under a reservation of rights, including the right to seek reimbursement for defending claims not covered by the liability policy. Ultimately, Pacific paid \$215,000 to defend the action and the bank paid an additional \$40,000 in fees and costs not paid by the insurer. Each asserted claims to recover their respective payment from the other.

Pacific sought to allocate costs to the various claims so that it would be reimbursed for all but that amount paid to defend the invasion of privacy claim. In addressing this novel issue, the Wyoming Supreme Court rejected the reasoning of *Buss* and adopted the minority rule that does not permit the allocation of defense costs. The court found that allocation would not be permitted if the cost of defending noncovered claims would have been incurred in defending the covered claims. In somewhat remarkable reasoning, the court observed:

The Policy required [the insurer] to defend [the insured] in any suit and not simply for specific claims. There is no indication in the Policy of any distinction to be made between covered and non-covered claims so far as the defense of those claims is concerned, and we will not permit the Policy to be modified by subsequent [reservation of rights] letters from the insurer to the insured.³¹

Conflicts and Other Unpleasantries

One might expect the introduction of this topic to feature a case gone horribly amiss and a subsequent bad faith claim by policyholder against insurer. But we will not venture there. In *Twin City Fire Insurance Co. v. Ben Arnold-Sunbelt Beverage Co. of S.C., LP*,³² the Fourth Circuit considered a case arising from underlying employment-related claims, including sexual harassment, emotional distress, civil conspiracy, and false imprisonment. While the policyholders retained counsel shortly after the claims were asserted, the matter was not reported to the insurer for another 14 months. The insurer then reserved its rights and agreed to appoint new counsel to defend the complaint, covered and non-covered claims alike.

The policyholders claimed the reservation created a conflict of interest, returned to their original counsel, and demanded the insurer pay all expenses incurred. After an unsuccessful negotiation, the insureds continued with the litigation, settling for \$515,000 and incurring \$1.4 million in defense costs.

The court first considered whether the reservation of rights

created a conflict sufficient to warrant the insured retaining its own counsel.³³ After considering a blanket rule for or against, the court, applying South Carolina law, rejected the insured's position, finding that a per se rule in favor of a conflict whenever a reservation issue arose would show remarkably "little confidence in the integrity of the members of the South Carolina Bar."³⁴ While factually complex, a fair reading of the court's holding indicates that no actual conflict existed: the insured breached its obligation of cooperation, and its claim for reimbursement of legal fees was accordingly rejected.

A contrary result is found in *CHI of Alaska v. Employers Reinsurance Corp.*³⁵ There, the facts line up a bit closer to the parade of horrors often contemplated in the context of an insured versus insurer conflict claim: a coverage claim involving negligence and intentional conduct, defense counsel appointed under a reservation to later disclaim, and a pointed objection by the insured that the "independent" counsel could manipulate the litigation toward a finding of intentional conduct in order to defeat coverage.

In addressing three distinct issues, the Supreme Court found that

1. where a policyholder does not consent to a non-waiver or reservation, the carrier can either defend without reservation or litigate the coverage issues;
2. appointment of defense counsel for covered claims and "permitting" the insured to have personal counsel defend the intentional claims does not meet the insurer's

- obligation of appointing independent counsel; and
3. given the totality of circumstances, the insured was well within its rights to select its own counsel to defend the entire matter.³⁶

Final Observations

When considering claims or complaints that at least raise the specter of covered and noncovered claims, insured and insurer would be well-served to carefully evaluate their respective positions, consider all available options, and be prepared to consider any reasonable alternative the other might suggest. Rather than a knee-jerk rejection of an insurer's suggested counsel, the policyholder may do well to "split the difference" and suggest a "neutral" firm. Instead of following the visceral instinct to resist defending a clearly noncovered claim, the insurer might seriously consider defending a mixed complaint. Whatever choices are available and ultimately settled upon, the analysis should start with choice of law, applicable state law on the duty to defend, and a cooperative effort between insurer and insured in order to discharge their respective obligations and minimize later conflicts. ■

Notes

1. See, e.g., *Fed. Ins. Co. v. Kozlowski*, 18 A.D.3d 33, 41 (N.Y. App. Div. 2005).

2. See *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7 (N.J. 1970).

3. Under the New Jersey Supreme Court's holding in *Burd* and its progeny, an insured may generally decline to defend an action, at least temporarily, when (1) a factual issue necessary to determine coverage will be unresolved in the underlying case, or (2) the

insured cannot defend the underlying case without the potential for a conflict between the policyholder's and the insurer's positions. *Id.* at 10–11. In these circumstances, the insurer should not provide a defense without a non-waiver agreement and instead should reimburse the policyholder for the cost of defending any covered claims after the action is completed.

4. See, e.g., *W. Cas. & Sur. Co. v. Int'l Spas of Ariz., Inc.*, 634 P.2d 3 (Ariz. Ct. App. 1981); *Dash v. Chi. Ins. Co.*, No. 00-11911-DPW, 2004 U.S. Dist. LEXIS 17309 (D. Mass. Aug. 23, 2004). In *Dash*, the district court understood that while both Illinois and New Jersey recognize that an insurer can recoup defense costs in actions containing covered and noncovered claims, that principle was not the law in Massachusetts and held that the insurer was not entitled to the apportionment of defense costs. *Id.* at *28–29, *34–35. In *International Spas*, the court noted that there was no Arizona precedent governing the issue and followed the apparent majority rule that "if any claim alleged in the complaint is within the policy's coverage, the insurer has a duty to defend the entire suit, because it is impossible to determine the basis upon which the plaintiff will recover (if any) until the action is completed." 634 P.2d 3 at 6.

5. 865 So. 2d 520 (Fla. Dist. Ct. App. 2003).

6. *Id.* at 522; see also *Colony Ins. Co. v. G & E Tires & Serv., Inc.*, 777 So. 2d 1034 (Fla. Dist. Ct. App. 2000). In *Colony*, the court recognized that the insurer timely and expressly reserved its rights to seek reimbursement of the cost of defending the uncovered claims, which it consistently identified through the proceedings. *Id.* at 1039. Should an insurer successfully challenge the coverage matter, an insurer should be entitled to the "full benefit of such a challenge and be reimbursed for the

benefits it bestowed, in good faith, to its insured.” *Id.*

7. 108 P.3d 469 (Mont. 2005).

8. *Id.* at 480.

9. 18 A.D.3d 33 (N.Y. App. Div. 2005).

10. *Id.* at 42.

11. 826 A.2d 107 (2003).

12. 633 F.2d 1212 (6th Cir. 1980), *clarified*, 657 F.2d 814 (1981).

13. 939 P.2d 766 (Cal 1997).

14. More specifically, the court in *Security Insurance Company of Hartford* concluded that “the insured would be unjustly enriched were we to conclude that there is no claim for reimbursement for the cost expended by the insurers in defending periods of self-insurance.” *Sec. Ins. Co. of Hartford*, 826 A.2d at 125. Thus, the court recognized that a course of action for reimbursement “is cognizable to the extent required to ensure that the insured not reap a benefit for which it has not paid . . .” *Id.*

15. 267 A.2d 7 (N.J. 1970).

16. 853 A.2d 974 (N.J. Super. Ct. App. Div. 2004). In contrast to *Burd v. Sussex Mutual Insurance Co.*, 267 A.2d 7 (N.J. 1970), policyholders often rely on several incompatible New Jersey decisions to maintain that an insurer is required to provide a defense, despite the apparent presence of a *Burd* conflict. The two most commonly cited are *Voorhees v. Preferred Mutual Insurance Co.*, 588 A.2d 417 (N.J. Super. Ct. App. Div. 1991), *aff’d*, 607 A.2d 1255 (N.J. 1992), and *L.C.S., Inc.*

t/a D’Jais Bar, Inc. v. Lexington Insurance Co., 853 A.2d 974 (N.J. Super. Ct. App. Div. 2004). In *Voorhees*, the court expressly declined to address the insurer’s duty to defend in the context of the potential conflict of interest with its insured, instead holding that “an insurer must bear the cost of defense when there is no reasonable means of prorating expenses between covered and non-covered claims.” 588 A.2d at 424. In *L.C.S., Inc.*, the appellate panel relied on the language in *Voorhees* and held that an insurer had an obligation to defend an action, even though there were assertions of both covered and noncovered claims. 853 A.2d at 983–84.

The New Jersey Appellate Division recently addressed the anomalous holdings in *Voorhees* and *L.C.S.* in *New Jersey Manufacturers Insurance Co. v. Vizcaino*, 920 A.2d 754 (N.J. Super. Ct. App. Div. 2007), and noted that the court’s statement in *Voorhees* was dictum, and that, since *Voorhees*, the New Jersey Supreme Court has reaffirmed *Burd* in *Morton International v. General Accident Insurance Co. of America*, 629 A.2d 831 (N.J. 1993). With respect to *L.C.S.*, the *Vizcaino* court conceded that the case cannot be reconciled with *Burd*. 920 A.2d at 760.

17. 853 A.2d at 985.

18. *Id.*

19. 607 A.2d 1266 (N.J. 1992).

20. 853 A.2d at 985.

21. 607 A.2d at 1280–81.

22. *Id.*

23. *Id.* at 1280 (citation omitted).

24. 851 A.2d 75 (N.J. Super. Ct. App. Div. 2004).

25. *Id.* at 84.

26. 448 F.3d 252 (4th Cir. 2006).

27. *Id.* at 258.

28. *Id.* at 264.

29. 2 P.3d 510 (Wyo. 2000).

30. *Id.* at 512.

31. *Id.* at 515.

32. 433 F.3d 365 (4th Cir. 2005).

33. *Id.* at 369–70; *see generally* *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc’y, Inc.*, 162 Cal. App. 3d 358 (Cal. Ct. App. 1984). The court in *San Diego* recognized that where a complaint alleges multiple theories of recovery against the insured, both covered and noncovered, a conflict of interest exists. *Id.* at 369. Counsel, representing both the insurer and the insured, each owed the other a high duty of care and must disclose all facts and circumstances to enable them to make intelligent decisions regarding continuing representation. *Id.* at 374. If the insured does not give an informed consent to continued representation, counsel must cease to represent both. If there is no consent given, an insurer must pay the reasonable cost for hiring independent counsel by the insured and may not compel the insured to surrender control of the litigation. *Id.* at 375.

34. 433 F.3d at 373.

35. 844 P.2d 1113 (Alaska 1993).

36. *Id.* at 1119 n.10, 1120–21.