Lowenstein Sandler's Insurance Recovery Podcast: Don't Take No For An Answer

Episode 89:
Allocation: Debunking the "Partial" Duty to Defend Myth

By Lynda Bennett, Alexander Corson

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Lynda Bennett: Welcome to, Don't Take No for An Answer. I'm your host, Lynda Bennett, chair of the Insurance Recovery Practice at Lowenstein Sandler. And today, I am very pleased to be joined by my associate and partner in crime, Alex Corson. So welcome to the show, Alex.

Alex Corson: Glad to be back. Thanks for having me.

Lynda Bennett: So Alex, the last time we were together we talked about the myths of other insurance where insurers try to shift part of their coverage obligation to each other. So I thought it might be a good idea to have you come back to talk to us about another way that carriers try to diminish their defense obligation through various allocation arguments that they put forward. And we're going to debunk some of those myths today.

So let me start with a prototypical stack pattern. We get the complaint and there are five counts in the complaint, three that are clearly covered and two that are potentially not covered. And we get the reservation of rights letter from the carrier, and they say, "We're going to acknowledge a partial obligation to defend." So what should they do when they get that reservation rights letter from the carrier?

Alex Corson: Well, of course the first thing they should do is give us a call and have us take a look at the policy and at the complaint and see what the actual answer to that allocation is. Because sometimes the carriers like to impose an allocation requirement that's not actually required by their policy and so you have to crack open the Forbes and take a look. The majority approach under a regular duty to defend policy that doesn't have some special language talking about allocation is that the right to a defense or a duty to defend is a right to a complete defense. They have to defend the whole thing, they can't start slicing and dicing up the claims and the parts of the claims and paying percentages. That's the majority approach that most jurisdictions take when the policy is silent on allocation.

Now there is a minority approach. Couple of states say, "Well, if you can show that there is a sliver of costs that are only being incurred on non-covered matters," for example, there's one claim that clearly falls in the exclusion., There's no two ways about it and the insured wants to move for partial summary judgment on just that count. Maybe the carrier could try to slice that out. But even in the minority approach, they're still paying when there's an overlap between covered and potentially non-covered matters, they're still paying for that overlap. It's only when there's a sliver that's completely not covered.

And so under the majority approach if there's no language, the general advice is push back, say, "No, I have a right to a complete defense. You can't offer me only a part of a defense and be consistent with your obligation with your duty to defend."

Lynda Bennett: So we got to break that down because it really brings up some of the bedrock principles that we often talk about here on Don't Take No for An Answer. The first one is the policy language matters. The second one is the jurisdiction matters, right? So where we typically see this, most of our clients when they get a lawsuit, it's an everything-and-the-kitchen-sink complaint where there are these several counts, there's routinely punitive damage. That's the easiest non-covered example that we can give. There's a punitive damage count that's asserted in the complaint along with negligence and lots of other legal causes of action that are likely covered under the policy.

And when we get that reservation or rights letter, the carrier is going to say, "Well, punitive damages are never insurable. I don't have to pay for that." And as you said, in a jurisdiction like New York for example, the law is very clear that if there is one even potentially covered claim, it doesn't have to actually be covered, potentially covered claim, that carrier has to pay 100% of the defense costs associated with that case, even when it has that punitive damage claim asserted. Even when the defense lawyer is going to file motions or find ways to eliminate that non-covered claim, all of that falls within the scope of coverage.

But as you said, there are other jurisdictions, and New Jersey's, one of them where... And it is the carrier's burden, that's very important too. It is the carrier's burden to identify a defense cost that is incurred exclusively for the benefit of that non-covered claim. So again, we guide our clients, even if you're in a jurisdiction like New Jersey where the defense costs may be subject to allocation, the reality is the vast majority of the defense costs are still going to be in that covered bucket because when you go to the case management conference and you're talking about the potential for filing your punitive damage motion, you still would have to attend that same case management conference to discuss all of the potentially covered claims. So all of those defense costs are covered.

And so while the carriers like to make a lot of noise about this, when this common law approach is in play, the reality is it's going to be a very narrow scope of costs that are going to fall into that non-covered bucket. And also, I think this is important to note too, that approach that most carriers take. Let's take a more extreme example where we have a 12-count complaint and 11

out of the 12 counts are not covered by the policy, but the one count that is negligence, for example, is what the case is really all about. What you have is an overly aggressive plaintiff's lawyer who thinks that they're going to scare the defendant by putting 12 legal causes of action in there. But really what the whole case is about is that one covered negligence claim.

It's really important for our clients to know the law is not a simple legal cause of action counting exercise, right? What are the kinds of arguments that we would make there, Alex, to say, "It's not one 12th coverage here"?

Alex Corson: Yeah. Well, in the policies that do have allocation language, usually what the language that they have there is relative legal liability, that you have to come to some type of agreement on how to split up the defense cost based on the relative legal liability. And in that case where you've got a 200-paragraph complaint and 150 of the paragraphs are detailing what happened, and it all sounds in negligence, this is you carelessly did this or that, and then they write out the 12 different counts and one of them is negligence and then the rest are all subject to an exclusion or some other, we say, "Well look, if you actually read what happened, if you read the basis for the liability, it all sounds in negligence, these are add-ons, right?"

And so we would take position that even if there was a right to allocation in the policy, the relative legal liability, you really have to drill down into what is the likelihood of actual liability? And not just counting up in a simple math exercise, how many counts like count one, count two, count three? Those could be nothing. Sometimes you see complaints with counts that are just a whole count dedicated to we want our attorney's fees even when there's no right to attorney's fee. So what's the real liability associated with that count? Basically nothing, right?

So we counsel clients not to just accept the basic rote mathematical approach and to push back and say, "Look, here's the nature of the allegations. This is really what this claim is about. A fair allocation would be 80% or 90%, not 12.5 or whatever it is."

Lynda Bennett: Right. And that's really an important point too, which is you get the reservation of rights letter, oftentimes it will say, "We're acknowledging a partial defense." And then you have the negotiation. They start with the claim counting exercise, and we really look at what is the gravamen of this complaint?

Now you mentioned, we were just talking about when the policy is silent on allocation, these are just arguments that the carrier will push and we look at what the law is. But as you mentioned, sometimes a policy will have an allocation provision, a specific allocation provision. And as you mentioned, sometimes that's as clear as mud where it says, "Well, we have to look at what the relative legal liability is," which leads you back to the same kind of negotiation we were just talking about.

But not all allocation provisions are created equal, right, Alex? So what's another variation besides that muddy relative legal liability kind of language? What else should policyholders be looking for there?

Alex Corson: Yeah. So this one's real important, especially when you're on renewal or you're changing carriers. You got to keep a lookout in the allocation provision because there's a number of ways that they like to frame this. The relative legal liability or something like that is usually the basis for the allocation, but what's really scary about some of these is they bake in alternative dispute resolution requirements like mediation. You got to arbitrate this if you can't come to an agreement. And in the worst cases, I've seen policies where they say, "We're supposed to work together to come up with a reasonable allocation, and if we can't agree, then we'll just pay what we think is reasonable."

So it's really important that you push back on this type of aggressive language when the policy is being placed because it really puts a lot of power early in the litigation or in the claims lifecycle in the carriers hands. And especially early in the case when there's not a lot of money incurred, it's not a lot of reason to go to war over the fence cost, the policyholder's sort of just stuck saying, "Well, I'll take what I can get for now and we'll see where this goes." It really puts a damper on the right to a defense.

Lynda Bennett: So a couple of variations that I've seen, and frankly some of these are getting harder to get through that negotiated process. But some policies in the allocation provision will differentiate between the duty to defend and the indemnity that comes later. A few years ago, you would be able to get an agreement that there would be 100% payment of defense costs and they would leave that muddy relative legal liability exposure language to deal with the indemnity aspect of this. That usually would require the policyholder also though, to agree that the carrier gets to defend the case, not the insured.

And so for some of our clients, we are able to negotiate. Let's move on to the third issue that really comes up oftentimes when we're dealing with these allocation questions, and that is when the carrier says, "Well, my policy's not on a duty to defend policy at all, so I'll see you later. I don't have to pay anything. My policy is an indemnity policy. My policy is a duty to reimburse policy." So what do you say about that, Mr. Corson?

Alex Corson: I wouldn't be delivering on my promise of busting some myths if we didn't talk about this one. Yeah, I mean, the reality is that the vast majority of courts that look at these policies where the duty to defend is, at least on the face, assigned to the policyholder, but the insurer is still paying for the defense costs. They treat it the same way they would a duty to defend policy in terms of whether it's triggered and the percentage and the allocation. It really all goes through the same lens because as you know, historically, policies just had a duty to defend or they didn't. For many decades, they were just duty to defend. So all the case law came up talking about a duty to defend. Well, carriers got clever in the last decade or so and started reframing it as, "Well, we're going to reimburse the defense costs or we're going to advance defense costs. We're not going to defend you. We're just going to pay for it."

And so the vast majority of the opinions that I've read on this issue say, "Nah. If we're talking about a defense cost that's upfront," right? A true indemnity policy where they're not defending, they say, "You go defend it and come to us when it's time for a judgment." Fine, then we're not talking about allocation

because there's no defense cost payment, right? But the majority of courts say, "If we're talking about a defense obligation, an obligation to pay or reimburse, that all needs to be analyzed in the same way that we would an ordinary duty to defend policy. There's nothing special about, "We're going to indemnify your defense costs." Basically, all courts have rejected this idea that it's an indemnity requirement to pay for defense costs.

Lynda Bennett: Right. Courts recognize that you're buying litigation insurance, and you need that to be paid along the way as you're defending the case. It's not that difficult, the concept to grasp, and courts certainly don't have a problem in doing that. Well, Alex, thank you very much for coming back on the show today to talk about another area where insurers tend to push a lot of myths that we're able to debunk, and I'll look forward to having you come back and talk about another topic along the same lines real soon.

Alex Corson: Thanks for having me. It was a lot of fun.

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