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Insurance Company Favorite: The “Loss Adjustment Expense”

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As you're evaluating your company's liability insurance program for 2015, consider closely the application of the policy's deductible. Specifically, take a look for any endorsement that defines “Allocated Loss Adjustment Expense,” or “ALAE,” to make sure the language matches up with what you think you are purchasing. Liability policies are usually sold with some form of deductible, which remains the policyholder’s obligation in the event a claim is asserted against the policyholder. In assessing its risk tolerance, an insurance purchaser may buy policies with higher or lower deductibles. The deductible applies to the insurance company’s obligation to indemnify for claims asserted against the policyholder. But most often, it does not apply to the costs of defense.

In other words, the defense obligation purchased by the policyholder is usually covered by its insurer from dollar one.

Some commercial liability policies contain endorsements (deductible liability endorsements) which require the policyholder to reimburse its insurance company for expenses incurred in adjusting a loss (loss adjustment expenses). The term “adjusting a loss” typically means the process of ascertaining the value of a loss or negotiating a settlement. Therefore, loss adjustment expenses are usually defined as those costs incurred by an insurance company in defending and/or settling a liability claim brought against its policyholder. These expenses can include fees charged by

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attorneys, investigators, experts, arbitrators, mediators, and other fees or expenses incidental to adjusting a claim. Deductible liability endorsements then define “loss adjustment expenses” as a part of damages payable to a claimant. By doing so, the “loss adjustment expense” is susceptible to the deductible. Thus, a policy with this type of endorsement does not provide first dollar defense to the policyholder. Instead, the policyholder, ultimately, will be responsible for defense and indemnity costs incurred, up to the stated deductible amount in the policy.

So what happens when, instead of accepting its obligation to defend its high-deductible policyholder, the insurance company denies that it owes a defense, and chooses to litigate coverage? The liability claimant will not wait to see how the coverage dispute gets resolved, but will continue to prosecute its claim against the policyholder, who is now forced to defend itself against two antagonists: the original liability claimant and its own insurance company. Our policyholder then incurs expenses to defend itself against the liability claimant (fees for attorneys, investigators, experts, mediators, etc.). Our policyholder pays for a strong defense and the claimant’s underlying case is resolved. Our policyholder also brings a breach of contract claim against its insurer, and ultimately prevails. But the insurance company says that it is still entitled to apply the deductible to ALL “damages” in the underlying claim.

“Damages” is defined in the endorsement to include all “loss adjustment expenses” as defined in the policy (including attorney fees). The “Allocated Loss Adjustment Expense” is that part of the adjustment expenses which is owed to the insurance company by the insured. But this doesn’t seem right. The “loss adjustment expense” is supposed to be the expenses incurred by the insurer when it lives up to its obligation to defend.

When the "loss adjustment expense" breaches that obligation by wrongly denying a defense, the policyholder has been deprived of the defense it paid for. The “loss adjustment expense” should not include expenses incurred by the policyholder in defending itself, without any assistance from the insurance company that pocketed the policyholder’s premium.

A careful read of the endorsement language may make clear that “loss adjustment expense” is not intended to include the policyholder’s attorney fees and defense costs when its insurer denies coverage and the policyholder successfully sues the insurer for breach. In this situation, where the insurance company has done no actual “adjusting” of the claim, it should not be entitled to apply its deductible to the expenses incurred by the policyholder in defending the abandoned claim.