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Maintaining Vigilance: A Carrier's Acceptance Of Its Coverage Obligations Is Only The Beginning

November 6, 2019 | Policyholder Protection,Risk Management

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You tendered a lawsuit to your liability carrier. You cooperated with its investigation of the claim, and maybe you had to challenge an initial denial. Now, you have a hard-earned letter from your carrier agreeing to defend the suit. This is a significant milestone in managing your risk arising from the liability, but the need for vigilance to maximize your insurance benefits and protect your rights is far from over. Whether there are thousands or millions of dollars at stake, policyholders must remain vigilant and active to ensure they are receiving maximum benefit from their coverage.

A multitude of disputes may still arise that can affect whether you maintain control over the defense and settlement strategy and decisions, and whether the carrier pays the full amount of defense costs and a settlement of the lawsuit.

Here are nine of the most frequent issues that arise after a carrier has acknowledged its duty to defend, all of which require the prompt attention of your risk manager, general counsel or outside coverage counsel.

1. CHOICE OF COUNSEL

Most primary liability policies give the carrier both the duty and the right to

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defend a lawsuit against the policyholder. This right to defend implicitly, and sometimes explicitly, includes the right to select defense counsel to defend the policyholder. A carrier's selection of counsel can be problematic for policyholders in many ways. Maybe the carrier chooses a lawyer who charges a very low hourly rate but has little experience in the area of law at issue in the suit. Maybe there is a risk that the lawyer is more loyal to the carrier than the policyholder. For example, the lawyer may serve as the carrier's go-to "panel" counsel for other, unrelated matters – with most, or all, of his or her invoices being paid by the carrier. Or maybe the carrier reserves its rights to later deny coverage, likely giving rise to a conflict of interest between the carrier and the policyholder.

A simple example is a toxic tort suit where the plaintiff asserts a variety of claims against the policyholder, ranging from strict liability to negligence to intentional conduct. The liability policy covers the strict liability and negligence claims but not the claim for intentional conduct. If the policyholder is ultimately held liable, it is in the policyholder's interest to be liable for negligent conduct or strict liability because those claims are covered by the policy. The carrier, however, has an incentive to steer the liability toward intentional conduct because that liability is excluded under the policy.

In this situation, the policyholder will be justifiably concerned that either the carrier or the carrier's chosen defense counsel, intentionally or unintentionally, may steer the defense away from coverage so that, if the policyholder is ultimately found liable, the liability is excluded, rather than covered, conduct. In instances where the carrier has appointed panel counsel who relies on insurers to keep their doors open, the concern becomes even greater.

Once such a conflict arises, in many states policyholders have the right to independent counsel (paid for by the insurer and selected by the policyholder or the policyholder and the insurer) with an independent duty of loyalty to the policyholder. Policyholders must affirmatively assert this right and request independent counsel. For example, the Minnesota Court of Appeals has recognized the concern that "counsel selected by the insurer will have a compelling interest in protecting the rights of the insurer rather than the rights of the insured because of counsel's closer ties with the insurer." Under Indiana law, conflicts giving the policyholder the right to choose counsel at the carrier's expense arise where "(1) the insurer may steer the defense so as to make the likelihood of a plaintiff's verdict greater under an uninsured theory; [and] (2) the insurer may offer a less than vigorous defense if the insurer knows that it can later assert non-coverage...."

California has even codified these principles: "[W]hen an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist."

Some states, like California, impose a duty to provide independent counsel where the insurer's reservation rights creates a qualifying conflict, meaning one presenting the opportunity for the carrier's chosen defense counsel to deflect the lawsuit's outcome away from coverage. Other states impose this duty whenever the insurer issues any reservation of rights. Still others require the insurer to pay for independent counsel not to protect the policyholder's right to coverage under insurance law, but to protect the insured's right to be defended by an unconflicted lawyer on professional liability grounds.

Knowing when and how to identify these conflict situations, and to exercise the right to select counsel at your carrier's expense, will make a significant difference in the quality of your defense and the confidence you have in it.

2. "REASONABLE AND NECESSARY" DEFENSE COSTS

Even when the policyholder with a duty to defend policy gains the right to choose independent counsel at the carrier's expense, the carrier may try to control rates and foist part of the costs onto the policyholder by claiming that independent counsel's rates are too high or that important defense activities (such as attorney conferences to strategize and to avoid duplication of effort, or multiple attorney participation in critical case events) are not "reasonable and necessary." Many jurisdictions have rejected these attempts and provided policyholders with tools to fight back.

For example, Illinois law recognizes that "[a]ttorneys must meet to discuss case strategy and other issues in the litigation. In fact, failure to meet would likely result in duplicative or non-essential work performed due to the lack of strategy or master plan." And Missouri law recognizes that "[h]aving several attorneys attend the same meeting or participate in the same conference call promotes the exchange of different perspectives on a particular legal strategy...."

Policyholders must adequately protect their rights on these issues, or they could end up facing a big chunk of the defense bill despite the carrier's agreement to provide independent counsel.

3. CONTROL OF DEFENSE AND SETTLEMENT

Liability policies with a duty to defend typically give the carrier the right to control defense and settlement decisions, but that right is not unconditional. Carriers must stay within the bounds of good faith, giving adequate regard to the policyholders' interests. Policyholders must vigilantly monitor their carriers' defense and settlement decisions to ensure that their interests are being protected and, if they are not, be prepared to exercise their rights.

Even if the carrier controls defense and settlement decisions, a policyholder's active participation in its defense is often critical to protecting against harm not covered by insurance. For example, while a defending insurer often gets to decide whether to settle or try the case, the policyholder may face serious reputational harm if it is not resolved before trial – harm that the policy does not cover, and to which the carrier may be indifferent. The policyholder must make sure the insurer understands that its duty of good faith includes an obligation not to allow collateral damage to the insured's interests from its decisions.

4. WHETHER THE POLICYHOLDER MUST CONTRIBUTE TO A SETTLEMENT

Even when a carrier is providing a complete defense, it may turn to its policyholder in certain circumstances to demand a significant contribution to the settlement. Carriers often contend that part of the settlement is excluded from coverage and demand that the policyholder contribute for "uncovered" portions. Policyholders can guard against this scenario, or at a minimum be prepared for the confrontation it will generate, by anticipating any coverage defenses the carrier may raise. Carriers are required to inform the

policyholder of potential coverage defenses well before the settlement stage in the reservation of rights letter that is typically issued when the carrier accepts the defense of the suit. The reservation of rights letter serves as a roadmap for sophisticated policyholders to follow in anticipating, and heading off, these gambits by the carrier.

The policyholder must be prepared to oppose these efforts and avoid or minimize its settlement contribution. This is another area where it is to a policyholder's advantage to have monitoring counsel and/or coverage counsel actively involved in the matter.

5. DISPUTES OVER WHETHER COSTS ARE DEFENSE OR INDEMNITY COSTS

This type of dispute typically arises in the environmental liability context, when a policyholder incurs attorneys' fees in responding to federal or state regulatory demands to investigate and clean up contamination rather than in defending against a courtfiled lawsuit. Even in this instance, legal costs incurred in dealing with regulators are typically recognized as defense costs. However, the bulk of the expenses a policyholder typically bears when dealing with regulators are not attorneys' fees, but rather the costs of engaging an environmental consultant to investigate and, if necessary, remediate the contamination or take other corrective action.

Whether environmental consultant costs count as defense or indemnity costs could make a big difference in the scope of your insurance recovery in at least two respects. First, liability policies with a duty to defend frequently agree to pay defense costs in addition to the policy limits, and defense costs are not subject to those limits. A carrier has an incentive to count environmental consultant expenses as indemnity costs that exhaust the policy limits and extinguish its coverage obligations faster, rather than as limitless defense costs paid outside policy limits. Second, the duty to defend is generally broader than the duty to indemnify. Carriers frequently agree to defend a suit but reserve the right to deny any obligation to indemnify the policyholder for a settlement or judgment. By classifying environmental consultant expenses as indemnity rather than defense, a carrier may be planning to avoid these costs altogether by denying a duty to indemnify. When these expenses are included in the insurer's duty to defend, which survives even if it refuses to indemnify some component of loss, the carrier cannot evade its duty to pay them.

A general rule of thumb that many courts have adopted (subject to the wording of the policies and the facts of a particular case) is to treat the costs to investigate contamination presumptively as defense costs akin to expert fees, and to treat costs to implement the remediation or other corrective action as an indemnity expense akin to payment of a judgment. For example, under New York law, "[p]olicyholders and insurance companies generally expect that a careful investigation of the insurer's potential liability will be provided by the insurer pursuant to its duty to defend." Similarly, under Minnesota law, "the fact that otherwise allowable defense costs serve the dual purpose of complying with the RFRA does not, in our estimation, render such costs indemnity costs."

This rule of thumb does not neatly sort all consultant costs into one category or the other, and there are some costs that are frequently disputed, such as the cost of conducting a feasibility study to evaluate various remedial options to select the most appropriate technique. Policyholders typically argue that

these costs are necessary to effectively negotiate a remedy with the regulators and should be treated as a defense cost. Carriers may argue that costs incurred to select a remedy are themselves remedial. Jurisdictions are split on this issue. Depending on the wording of the policies, the facts of a particular case, and the applicable law, the policyholder may be able to maximize its recovery by pushing as much of the environmental consultant costs as possible into the carrier's duty to defend.

6. PRE-NOTICE COSTS

Even where an insurance company accepts the duty to defend, it may still deny an obligation to pay defense or mitigation costs the policyholder incurred before the carrier was notified. State law varies on whether, and under what circumstances, these pre-tender costs are covered. Some states allow partial or complete recovery of these costs under certain circumstances, such as when the carrier cannot show that it was "prejudiced" by the pre-notice activities undertaken without its knowledge or consent. Other states have a bright-line rule that pre-notice costs are not recoverable. Knowing which state's law applies, and knowing your rights under that state's law, are critical to an understanding of whether the policyholder has an opportunity to recover pre-notice costs from the carrier.

7. RECOUPMENT OF DEFENSE COSTS

Carriers often purport to reserve a right to reimbursement of monies spent defending the policyholder if, ultimately, it is determined that the carrier does not owe a duty to indemnify. Policyholders must promptly and expressly object to any such reservation of this purported right, often found in the reservation of rights letter. Unless there is an express recoupment provision in the policy, there should be no basis for a carrier to impose such a requirement, and courts in many (but not all) jurisdictions have agreed. A reservation of rights letter that includes a reservation of a purported right to recoup defense costs should be treated as a red flag, and the policyholder should expressly object to the carrier's attempt to reserve that purported right.

8. NATIONAL COORDINATING COUNSEL

For policyholders facing recurring liability exposures throughout the country, such as asbestos or toxic tort suits, it may be essential to the policyholder's overall defense strategy to appoint attorneys from one or more firms to serve as national coordinating counsel. National coordinating counsel oversees the defense of all such suits to ensure that discovery positions and expert testimony are consistent across cases, and to avoid taking inconsistent positions on litigation and settlement strategy. Carriers sometimes contend that the duty to defend does not include a duty to hire and pay national coordinating counsel; rather, their obligation extends only to hiring local counsel to defend each individual suit without regard to coordination.

Insurers of the product liability of large corporations usually are experienced enough in this line of business that they recognize the value of coordinating counsel and are willing to pay for it. Relatively few jurisdictions have addressed whether coordinating counsel fees are covered, but those that have tend to recognize this as a "reasonable and necessary" defense cost the carrier must pay.

9. MULTIPLE-CARRIER SITUATIONS

All of these issues become more complex when more than one carrier owes an obligation to defend or indemnify the policyholder in the same suit. These situations often arise for long-tail claims, which trigger a multitude of historical primary and excess policies issued by different carriers over a period of several years. Fundamental questions arise, such as how defense and indemnity costs are apportioned or allocated among carriers, and the policyholder's ability to select which policies are triggered and exhausted and in what order. The order of triggering and exhausting can significantly impact whether and to what extent the policyholder must contribute a portion of the defense and indemnity costs for uninsured periods, self-insured periods or periods for which a carrier has declared bankruptcy.

Multiple-carrier situations can also complicate the potential for conflicting interests and objectives among the carriers. Issues discussed above, such as whether the policyholder or the carrier has the right to select counsel and control the defense, can become much more difficult to resolve, especially when different carriers are agreeing to defend under different conditions and reservations and, potentially, different policy language. If the policyholder is unaware of its rights on these issues and does not aggressively protect them, it may end up saddled with a significantly larger contribution than it is obligated to pay. Having a risk manager, in-house counsel or outside coverage counsel actively advocate for the policyholder's interests is essential in navigating the pitfalls created when multiple carriers are involved and in maximizing benefits from the carrier group.

CONCLUSION

In summary, even after you have obtained a carrier's agreement to defend and cover a lawsuit, in many instances your work has only just begun. The issues above can be worth millions of dollars to policyholders. It is worth protecting your company's rights by identifying and addressing these issues when – and possibly before – they arise.

This article was originally published in the Fall 2019 edition of Corporate Policyholder Magazine. View the full publication for a footnoted version of this article.