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How to Safeguard Your Coverage Position

I. Early Considerations for Coverage Defenses

Understanding the Nature and Impact of the Coverage Defense is Key

Before the insurer considers the various steps, it must take to preserve its coverage defenses for a particular claim or lawsuit, the insurer must first understand the nature of the defense and the potential impact the course of the litigation may have on the insurer's ability to maintain the defense. It is relatively common that a particular lawsuit will assert claims against an insured for which coverage is potentially afforded for only part of the claim. In that scenario, the insurer (and the insured) must determine how to properly advance the coverage defense to ensure that any eventual damages awarded against the insured are allocated between covered and uncovered damages. While this will allow both the insurer and the insured to understand their respective financial obligation for any awarded damages, accomplishing this desired outcome is not always easy.

Some Defenses Are Not Impacted by Allocation

Not all coverage defenses are impacted by the damages that may be awarded against the insured. Thus, the insurer's assessment of the need for an allocated verdict should begin here. An insurer should first consider the nature of its coverage defense to determine whether an allocation of future damages will be necessary. Generally, policy defenses that are not dependent upon evidence adduced in the underlying lawsuit will not warrant a request for an allocated verdict. Specifically, these coverage defenses could include (1) lack of cooperation, (2) late notice, (3) policy interpretation, (4) misrepresentation by the insured, and (5) pre-policy knowledge of a loss. For each of these defenses, the ultimate outcome of the insured's liability in the underlying case is not dispositive of the insurer's successful assertion of the coverage defense.

When the coverage defense is untethered to the ultimate outcome of the underlying litigation, insurers generally pursue declaratory judgment actions against their insureds (or simply deny outright) to seek a judicial determination of their coverage obligation. While some of these coverage defenses may be strengthened or weakened depending on the evidence adduced in the underlying litigation (e.g., pre-policy knowledge of a loss), they do not require a

damages allocation and are generally unburdened by the finality of the underlying lawsuit. There are, of course, other jurisdictional considerations that could impact the insurer's ability to disclaim coverage, which the insurer will also have to consider in assessing its next steps relative to these coverage defenses (e.g., four-corners duty to defend, true but unpled facts, etc.).

Defenses Impacted by The Ultimate Evidence Require Allocation

When an insured is sued for both covered and uncovered damages, an insurer must take steps to preserve its ability to disclaim coverage for the uncovered aspect(s) of the claim. Again, understanding the nature of the defense is critical in determining whether to pursue an allocated award. Where the evidence adduced in the underlying litigation can impact the successful assertion of a coverage defense, the insurer must take steps to preserve its right to disclaim indemnity for any non-covered damages. Examples include (1) whether the suit alleges an "occurrence" (e.g., a complaint assert negligence and fraud claims), (2) whether an expected or intended or intentional acts exclusion applies, (3) whether various business risk exclusions apply, and (4) whether the complaint seeks punitive damages (vicarious or directly assessed). How to accomplish the proper preservation of the coverage defense, including the request for an allocated verdict, is not always as simple as issuing a reservation of rights letter.

II. Issuing Your Reservation of Rights Letter

The Letter Should Be Sufficiently Detailed to Preserve the Defense

Once the coverage defenses have been properly identified, the insurer should document its coverage defenses through the issuance of a reservation of rights letter. Unfortunately, there is no hard and fast rule or jurisdictional consensus as to how to properly present the coverage defenses, including the language necessary to ensure the defense is properly preserved. As a general matter, the reservation of rights letter should contain the provision(s) on which the insurer is relying and identify facts either pled in the underlying pleading or known to the insurer supporting the defense.

The Letter Should Identify the Need for an Allocated Verdict

In the event the underlying lawsuit seeks covered and non-covered damages, courts are increasingly requiring insurers, including, in some jurisdictions, excess insurers, to detail their coverage defenses in the reservation letter and advise the insured of the availability and desirability of an allocated verdict and the potential conflict occasioned by the allocation issue. This requirement has its genesis in the 5th Circuit case of *Duke v. Hoch*, 468 F.2d 973 (1972) (applying Florida law), which involved a garnishment suit in which a judgment creditor sought the proceeds of a liability policy insuring the judgment debtor.

The need for the identification of non-covered damages and the insurer's request to the insured that it seek an allocated verdict is based, as an initial matter, on the fact that the insurer has generally retained counsel to defend the insured in the underlying lawsuit. As the *Duke* court observed, once a complaint seeks both covered and non-covered damages, the insurer's and the insured's interests diverge and it is not enough at that point that the insurer simply reserve rights as to the non-covered damages and await a final resolution and damage award

against the insured. Again, while there is no specific language that must be included in the reservation of rights letter to properly preserve the issue, the earlier and more detailed the insurer is in presenting its coverage defenses and advising of the need for an allocated verdict could provide the insurer the support it may need post-verdict to disclaim coverage for all or a portion of the awarded damages.

A detailed identification of the insurer's coverage defenses could also serve as a negotiation tool in the event the insurer seeks to settle the underlying litigation. Depending on the financial viability of the insured, the existence of damages for which no coverage may be afforded under the policy could incentivize an underlying plaintiff to resolve the matter for an amount less than the verdict he/she might ultimately be able to obtain against the insured. There, the underlying plaintiff avoids the costs associated with post-verdict efforts to collect the judgment, including potentially protracted coverage litigation associated with the insurer's coverage defenses.

The Insurer Should Monitor the Facts to Further Support Coverage Defenses or Add New Defenses

Oftentimes the existence of a coverage defense is not readily apparent from the complaint against the insured. Moreover, litigation is ever evolving, including the supplementation of pleadings to assert new causes of action potentially developed during the discovery process. Insurers should be diligent in monitoring the status of the underlying litigation, including discovery conducted amongst the parties, to determine whether the insurer should take steps to reserve its rights as to any coverage defenses. This is particularly true when the insured is controlling its own defense through its own retained defense counsel, who may not be as forthcoming with case developments as an insurer-retained defense counsel.

While a primary insurer is generally more involved in the day-to-day aspects of the underlying litigation, excess insurers should also endeavor to assert any coverage reservations it may have relative to the underlying lawsuit. For example, in the event the primary insurer believes the insured's exposure exceeds the limits of the primary policy, the primary insurer may not take the appropriate steps to ensure the verdict is allocated between covered and non-covered damage. Thus, it benefits an excess insurer to issue a reservation of rights letter to the insured and to actively monitor the underlying litigation to ensure the coverage defenses are being appropriately preserved, including the request for an allocated verdict.

III. Verdicts and Understanding the Burden to Establish Coverage

General vs. Special Verdicts

State and federal courts have pattern jury instructions and verdict forms for most causes of action. These instructions, including any case-specific modifications thereto, are generally proposed by the parties and approved by the court prior to a case being presented to a jury for deliberation. A general verdict generally favors one party over the other and simply instructs the jury to award several damages supported by the evidence. The biggest problem with a general verdict from an insurer's perspective is that it does not always account for coverage issues or allocate the award among the various causes of action alleged by the

plaintiff. The Federal Rules of Civil Procedure also allow for general verdicts with accompanying special interrogatories, which is more akin to a special verdict.

Special verdicts require a jury to return a special verdict in the form of written findings as to each issue of fact. These verdicts are becoming more commonplace than a general verdict. The special verdict instruction can be made by (1) submitting written questions requiring a categorical or other brief answer, and/or (2) submitting written forms of the special findings that might properly be made under the pleadings and evidence. The special verdict requires the jury to answer case-specific inquiries that may then be used to answer questions of coverage under the policy. It may also be used as tool to determine what portion of the damages awarded are attributable to covered versus non-covered claims.

Who has the Burden to Establish Coverage?

As a general matter, all (if not the vast majority) of states hold that the insured bears the burden of establishing the existence of coverage under the policy. Thus, if the verdict does not allocate the damages to account for covered and non-covered claims, the insured risks the potential that it will not be able to demonstrate what part of the verdict is properly apportioned to the covered claim, which could, in some jurisdictions, result in the complete preclusion of coverage for the verdict.

However, courts will consider the facts and circumstances of each case to determine whether the burden should be shifted to the insurer. Recent decisions have considered the following factors in determining the burden holder:

(i) whether the right to allocate was set forth in a reservation of rights letter.
(ii) whether the insured was provided notice in writing of the need to allocate any potential settlement or judgment.
(iii) whether the policyholder was advised of any potential divergent interests.
(iv) whether the policyholder had knowledge of the import of allocating any potential settlement or the need to request a special verdict form that provides for allocation.
(v) whether the insurer was actively involved in the settlement process; and
(vi) whether the insurer took pro-active steps for the use of a special verdict form at trial

This burden shifting was addressed in the *Duke* case. After a general verdict was rendered against the insured, a garnishment proceeding was commenced against the insurer seeking recovery of the verdict. The insurer satisfied its initial burden to demonstrate the existence of non-covered damages in the verdict, which shifted the burden to the insured to prove the precise portion of the unallocated verdict covered by the policy.

Despite concluding that the insured failed to meet its burden, the *Duke* court nevertheless expressed concern with the relative impossibility and associated inequity occasioned by a post-verdict challenge to an unallocated verdict against the insured, whose defense was being controlled by the insurer under a reservation of rights. Finding that the insurer's assumption of the insured's defense included an obligation to inform the insured of the need for a special verdict allocating damages, the *Duke* court relieved the insured of its burden

to identify the covered portion of damages represented by the verdict. However, the *Duke* court did not require the insurer to indemnify the entire verdict but left the issue of allocation to the trier of fact whose decision would be based on evidence proffered by the parties. The initial burden, however, was on the insurer, which would be responsible for the entirety of the verdict if it were unable to carry its burden as to which part of the verdict represents non-covered damages.

The *Duke* case recognizes an insurer's ability to discharge its responsibility relative to the allocation issue by notifying the insured of its interest in the form of the verdict. Thus, in situations in which the insurer is controlling the defense or, in some jurisdictions, simply monitoring the underlying litigation, the insurer should endeavor to communicate its coverage position with the requisite specificity dictated by the jurisdiction, including the availability and desirability of a special verdict.

Again, the sooner the insurer notifies the insured of these divergent interests and the need for an allocated verdict the better position the insurer will be in if the verdict is rendered in an unallocated manner. However, the issuance of a reservation of rights letter, without more, can be insufficient to protect an insurer from the possibility that a court will shift the burden to the insurer to demonstrate what portion of the verdict was not covered by the policy. As this process could require a subsequent trial on the coverage issues, the insurer should take proactive steps during the litigation and trial to enforce its coverage defenses. The insurer should, of course, create a record that documents these efforts.

IV. Steps to Seek an Allocated Verdict

While some jurisdictions do not require an insurer to take additional affirmative steps beyond notifying its insured of the need to allocate a verdict, others require a more proactive approach that would interject the insurer into the pre-trial process, including notifying the trial court of the need for special interrogatories and even seeking to intervene in the underlying litigation if necessary.

Special Interrogatories

Special interrogatories are a set of interrogatories or questions posed to the jury to determine a specific issue or answer a fact. These interrogatories can be a tool for the insurer to ensure that the verdict is appropriately allocated and that coverage-determinative questions are answered by the jury in the context of its award. Like a request to the insured that it seek an allocated verdict, notifying the insured in the initial reservation of rights letter that special interrogatories may be necessary to address the insurer's coverage defenses is prudent. Of course, having the special interrogatories posed to the jury is more challenging.

As an initial matter, the insurer is not generally a party to the underlying litigation and thus, unable to direct the court as to the issuance of special interrogatories. Additionally, most states do not permit the jury to hear evidence of insurance coverage so as not to prejudice the defendant by an inflated damage award. Finally, the insurer may have a challenging time obtaining the insured's and its defense counsel's cooperation in proffering the interrogatories to the court, as the basic purpose of the interrogatories is to identify aspects of the damages figure

for which coverage may not be provided. Although defense counsel is generally retained by the insurer to defend the insured, counsel's duty lies with the insured. This would also be true in situations in which the insured retains its own counsel because of a large, self-insured retention or through a jurisdictionally required offer of independent counsel (which may be required if the complaint seeks both covered and non-covered damages).

The Insurer May Be Required to Intervene in the Underlying Lawsuit

If the insurer is unable to obtain the cooperation of its insured in seeking the use of special interrogatories, the insurer may be obligated to intervene in the underlying litigation to assert its rights. While, again, most jurisdictions prohibit the identification of insurance for the jury, some states are nevertheless requiring the insurer to intervene in the underlying litigation or risk losing its right to challenge coverage for the verdict.

While courts in some jurisdictions expressly authorize an insurer's intervention (e.g., Wisconsin, Florida, Nevada, etc.), other states have denied an insurer's request to intervene (e.g., Illinois, California, Indiana, etc.). Other states, however, have specifically required that the insurer intervene and its failure to do so prohibited the insurer from later seeking to allocate the verdict (e.g., Vermont, Pennsylvania, Delaware, etc.) Thus, it is important to understand the specific jurisdiction's law as to the insurer's right and/or obligation to intervene.

There are two types of intervention: permissive intervention and intervention as a matter of right. Permissive intervention is a procedure granted by a court that allows a third party not originally involved in an existing lawsuit to join with either the plaintiff or defendant. Permissive intervention may be allowed at the discretion of the trial court when an applicant's claim or defense and the main action have a question of law or fact in common. To be allowed permissive intervention, an insurer must establish an independent basis for subject matter jurisdiction or risk denial of its request.

Intervention as a matter of right will be granted to a party that successfully demonstrates four requirements:

(1) the motion must be timely.
(2) the proposed intervenor must claim an interest relating to the property or transaction at issue.
(3) the disposition of the action, as a practical matter, may impair or impede the ability to protect that interest; and
(4) that interest is not adequately represented by existing parties.

Although there is no set definition of what qualifies as an "interest," it generally must be a direct and substantial interest that is not too remote from the matters at issue in the litigation. There are also additional considerations found in the Federal Rules of Civil Procedure to address the request to intervene. Those factors are as follows:

(i) the length of time during which the would-be intervenor knew or reasonably should have known of his interest in the case before he petitioned for leave to intervene.
(ii) the extent of prejudice to the existing parties because of the would-be intervenor's failure to apply as soon as he knew or reasonably should have known of his interest.
(iii) the extent of prejudice to the would-be intervenor if his petition is denied; and
(iv) the existence of unusual circumstances militating either for or against a determination that the application is timely.

Intervention can be an important and effective tool in addressing allocation between covered and non-covered damages. An insurer should first reserve its rights to seek an allocation of damages and pursue the insured's cooperation in proffering appropriate special interrogatories to the jury. While the insured's refusal could make it more difficult for the insured to subsequently defend a post-verdict challenge to coverage for the verdict, courts are requiring insurers to take additional steps to exhaust all potential avenues available to the insurer to allocate the award, including intervention in the underlying litigation. In jurisdictions in which intervention is not presently allowed, the insurer may nevertheless want to consider bringing the matter to the court for a ruling, even just for the limited purpose of proposing special interrogatories, which would preserve the coverage defense and demonstrate the insurer's efforts to address the matter before judgment.