

INSURANCE LAW: HOT TOPICS FOR A NEW DECADE

2010 Seminar Material

Moderator

Marc L. Dembling, Esq.
Certified by the Supreme Court of New Jersey as a Civil Trial Attorney
Methfessel & Werbel, P.C.
(Edison; New York City)

William J. Pollinger, Esq.
Certified by the Supreme Court of New Jersey as a Civil Trial Attorney
William J. Pollinger, P.A.
(Hackensack)

Speakers

Lynda A. Bennett, Esq.
Herold Law, P.A.
(Warren)

Fredric Paul Gallin, Esq.
Certified by the Supreme Court of New Jersey as a Civil Trial Attorney
Methfessel & Werbel, P.C.
(Edison; New York City)

Christopher P. Leise, Esq.
Certified by the Supreme Court of New Jersey as a Civil Trial Attorney
White & Williams LLP
(Cherry Hill)

Anthony J. Monaco, Esq.
Law Offices of Anthony J. Monaco
(Freehold)

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New Jersey's Ever Evolving Duty To Defend Law

By

Lynda A. Bennett, Esq.¹

Generally speaking, a liability insurance policy is designed to provide two forms of insurance protection to a policyholder: defense coverage and indemnity coverage.

The duty to indemnify comes into existence only after a judgment has been entered, or a settlement has been reached, whereby the policyholder is legally obligated to pay damages to a third party. The indemnity obligation exists until the full amount of the policy limit has been paid or the claim has been resolved within the available limits of the policy.

The duty to defend is supposed to be much broader than the duty to indemnify. Rosario v. Haywood, 351 N.J. Super. 521, 534 (App. Div. 2002). For example, an insurance company must defend *potentially covered* as well as *actually covered* claims asserted in a complaint. See Voorhees v. Preferred Mut. Ins. Co., 128 N.J. 165, 180 (1992). Moreover, when a complaint presents “mixed” allegations, some of which are potentially or actually covered by the policy and others of which are not, “the duty to defend will continue until every covered claim is eliminated.” Id.;² see also Schmidt v. Smith, 294 N.J. Super. 569, 590-91 (App. Div. 1996), aff'd 155 N.J. 44 (1998). All ambiguities regarding the obligation to defend are supposed to be resolved in favor of the policyholder. See Sears Roebuck & Co. v. Nat'l Union Fire Ins. Co.,

¹ Ms. Bennett is a Shareholder with Herold Law, P.A. She is the immediate past Chair of the Insurance Law Section of the New Jersey State Bar Association. Ms. Bennett frequently speaks and writes about insurance coverage issues. Her practice is focused exclusively on the representation of policyholders.

² The Appellate Division recently questioned whether the above quoted language was merely dictum as opposed to a holding that was essential to the New Jersey Supreme Court's decision in Voorhees. See New Jersey Mfrs. Ins. Co. v. Vizcaino, 392 N.J. Super. 366, 373 (App. Div. 2007).

340 N.J. Super. 223, 241 (App. Div. 2001); Aetna Cas. & Sur. Co. v. Ply Gem Indus., Inc., 343 N.J. Super. 430 (App. Div. 2001).

New Jersey, however, has long been known for its unique approach to addressing the scope of an insurer's defense obligation. From this policyholder lawyer's perspective, New Jersey law falls out of step with courts across the country regarding many important defense-related issues which results in an overall diminishment of the defense litigation insurance that policyholders purchase from their insurers.

This article provides an overview of New Jersey's general rule on the duty to defend. It then addresses New Jersey's Burd exception, which allows insurers to convert their duty to defend into a duty to reimburse in certain circumstances. Next, the article discusses New Jersey's rules regarding apportionment and allocation of defense costs. Finally, this article addresses recent New Jersey case law regarding the use of extrinsic evidence that further elucidates the insurer's duty to defend and which may reinforce New Jersey's outlier status on duty to defend issues.

New Jersey's General Rule on The Duty To Defend

An insurer's duty to defend arises whenever the complaint against the insured "states a claim constituting a risk insured against." Danek v. Hommer, 28 N.J. Super. 68, 77 (App. Div. 1953). To determine whether an insurer has a duty to defend, the complaint is "laid alongside the policy" to compare the allegations with the language of the policy. Id. The duty to defend arises when the comparison reveals that if the allegations of the complaint are sustained, the

insurer will be required to pay any resulting judgment.³ Sears Roebuck & Co., 340 N.J. Super. at 241.

The duty to defend is not abrogated if the claim has no merit, either in law or in fact, because insurers agree, through the insurance contract, to defend causes of action even if they are groundless, false or fraudulent. Voorhees v. Preferred Mut. Ins. Co., 128 N.J. 165, 174 (1992); L.C.S., Inc. v. Lexington Ins. Co., 371 N.J. Super. 482, 490 (App. Div. 2004). Additionally, the insurer's defense obligation is triggered when the complaint alleges "a cause of action which *may potentially come within the coverage of the policy, irrespective of whether it ultimately does come within the coverage* and hence irrespective of whether the insurer is ultimately obligated to pay." Hartford Ins. Group v. Marson Constr. Corp., 186 N.J. Super. 253, 257 (App. Div. 1982) (emphasis added); Sahli v. Woodbine Bd. Of Educ., 193 N.J. 309, 322 (2008). See also Ohio Cas. Ins. Co. v. Flanigan, 44 N.J. Super. 504, 512 (1965) ("The nature of the damage claim, rather than the ultimate liability of the insurer, determines whether the insurer is obligated to defend"); Danek, *supra*, 28 N.J. Super. at 77 ("liability of the insured to the plaintiff is not the criterion; it is the allegation in the complaint of a cause of action which, if sustained, will impose a liability covered by the policy").

Any doubts regarding the duty to defend are resolved in favor of the insured. Sears Roebuck & Co., 340 N.J. Super. at 241. This is so because "a third party does not write the complaint to apprise the defendant's insurer of potential coverage." Voorhees, 128 N.J. at 174. The duty to defend is determined by whether a covered claim has been made, not by how well it is made. See Jolley v. Marquess, et al., 393 N.J. Super. 255, 272 (App. Div. 2007).

³ The same analysis applies with respect to counterclaims that may be asserted against a policyholder. See Hebela v. Healthcare Ins. Co., 370 N.J. Super. 260, 268-69 (2004).

If there is a dispute regarding the insurer's defense obligation, the burden is placed on the policyholder in the first instance to demonstrate that the claim potentially falls within the scope of coverage conferred by the insuring agreement and policy definitions within the policy. FileNet Corp. v. Chubb Corp., 324 N.J. Super. 476, 484 (Law Div. 1997). If the insurer seeks to avoid its defense obligation by relying on a policy exclusion, the burden shifts to the insurer to demonstrate that the policy exclusion applies. See Robert W. Hayman, Inc. v. Acme, 303 N.J. Super. 355, 357 (App. Div. 1997).

The duty to defend is not necessarily limited to what is set forth in the complaint. See Jolley, 393 N.J. Super. at 271. Policyholders are permitted to use extrinsic evidence i.e., facts developed outside of the complaint allegations, to establish the insurer's defense obligation. See SL Industries, 128 N.J. at 198-99 ("facts indicating potential coverage that arise during the resolution of the underlying dispute...may trigger the duty to defend").

The New Jersey Supreme Court has held that the use of extrinsic evidence to establish a defense obligation is necessary to fulfill the policyholder's reasonable expectation of coverage:

Insureds expect their coverage and defense benefits to be determined by the nature of the claim against them, not the fortuity of how the plaintiff, a third party, chooses to phrase the complaint against the insured. To allow the insurance company to construct a formal fortress of the third party's pleadings and to treat behind its walls, thereby successfully ignoring true but unpleaded facts within its knowledge that require it, under the insurance policy, to conduct the putative insured's defense would not be fair.

Id.

Thus, a policyholder may be in a position to challenge an initial denial of defense coverage by providing an insurer with later developed facts contained in interrogatory answers, deposition testimony, and/or expert reports which trigger actual or potential coverage under the

policy for the claim asserted. Note, however, that an insurer has no affirmative duty to investigate facts which may trigger coverage. Id. at 199.

The issue of whether insurers may use extrinsic evidence to eliminate their defense obligation is a matter currently in dispute under New Jersey law. As discussed further below, the Appellate Division has rendered two conflicting opinions within the last year on this issue.

New Jersey's Burd Exception

Notwithstanding that New Jersey follows the above general rules, which are largely consistent with the duty to defend rules followed by courts across the country, New Jersey is the only jurisdiction that allows insurers to convert their duty to defend into a duty to reimburse in certain, limited factual scenarios. The ramifications of this exception to the general rules governing defense cost coverage can be financially devastating to policyholders and can result in a significant reduction in the overall coverage available for a claim. As discussed below, at its core, the "Burd Exception" requires policyholders to: (a) fully fund the defense of the underlying action out of their own pocket, and then (b) fully fund a subsequent insurance coverage litigation before the insurer is required to pay one penny in defense costs. Moreover, when the insurer finally pays, only a portion of the fees incurred may be reimbursed.

The mischief began in Burd v. Sussex Mut. Ins. Co., 56 N.J. 383 (1970), where a policyholder was sued for injuries sustained as a result of a shooting.⁴ The Complaint contained

⁴ Hartford Acc. & Indem. Co. v. Aetna Life & Cas. Ins. Co., 98 N.J. 18 (1984) is often cited in tandem with the Burd decision. However, the Hartford decision is not really applicable to the discussion of the duty to defend because it involved a dispute between two insurers. Indeed, the Supreme Court acknowledged that "no question of the duty to provide interim financing of defense costs is posed in the current procedural posture of this case." Id. at 24-25. Nevertheless, insurers contend that Hartford reinforced the Burd decision because the Court endorsed one insurer's "wait and see" approach on the payment of defense costs. The insurer contended that the underlying action would not, and did not, resolve certain trigger and allocation coverage questions presented. The Supreme Court agreed. Id. at 25.

two counts: one for negligence and one for intentional infliction of harm. Thus, the Burd court was faced with the classic example of a “mixed” complaint alleging both potentially covered (negligence-based) and non-covered (intentional-based) claims.

Courts in virtually every other jurisdiction faced with this dilemma have required the insurer to defend the entire action. See e.g. Trizec Properties v. Biltmore Construction Co., 767 F.2d 810, 811 (11th Cir. 1985); Horace Mann v. Barbara B., 846 P.2d 792 (1993)(“We look not to whether noncovered acts predominate in the third party’s action but rather to whether there is any potential for liability under the policy. Since an insurer has a duty to defend the entire third party action if any claim encompassed within it potentially may be covered...the mere fact that [the insurance company would not be required to indemnify the insured for non-covered claims] did not eliminate its duty to defend other, possibly covered claims”); Sauer v. Home Indem. Co., 841 P.2d 176, 181 (Alaska 1992)(“the duty to defend is triggered if there is at least one cause of action alleged in the complaint for which there is a possibility of coverage under the policy and that the presence of additional causes of action not covered by the policy does not defeat the duty to defend”); Commerce & Indus. Ins. Co. v. Bank of Hawaii, 832 P.2d 733, 736, recon. den. 834 P.2d 1315 (Haw. 1992)(“where a suit raises a potential for indemnification liability of the insurer to the insured, the insurer has a duty to accept the defense of the entire suit even though other claims of the complaint fall outside the policy’s coverage”); MGM, Inc. v. Liberty Mut. Ins. Co., 855 P.2d 77, 79-80 (Kan. 1993)(“the duty to defend arises whenever there is a ‘potential of liability’ under the policy...Where the complaint alleges both a negligent and intentional act, these alleged facts give rise to the potential for liability and the duty to defend arises”); North Star Mut. Ins. Co. v. Kneen, 484 S.W.2d 908, 912 (S.D. 1992)(finding duty to defend based on potential coverage of a complaint alleging both covered and non-covered claims); Robertson v.

Fowler, 475 S.E.2d 730, 735 (W. Va. 1996)(“inclusion of some non-covered claims in a complaint does not abrogate the insurer’s duty to defend when the complaint raises claims that are covered by the policy”).

However, in Burd, the New Jersey Supreme Court allowed the insurance company to declare that a “conflict of interest” precluded its contemporaneous involvement in the underlying defense. Burd, 56 N.J. at 389. The Burd court was concerned with the possibility that the policyholder would be prejudiced if the insurance company controlled the defense of the lawsuit while disputing coverage. Id. at 391. The Court also expressed concern that the insurer may be stopped from denying coverage in a subsequent coverage action if it chose to provide a defense. Id. at 394.

Thus, the Court held that insurers should not participate in the underlying defense of a lawsuit against a policyholder: (1) if a conflict of interest exists such that the insurer may be tempted to “steer” the defense of the underlying suit toward a finding of liability based on a non-covered cause of action; or (2) where all coverage issues may not be resolved upon the final disposition of the underlying action. Id. at 391-394. In those circumstances, the Court held that the insurance company must reimburse the policyholder for defense costs only after it is shown that the underlying claims (or some portion of them) are covered by the policy. Id. at 394. See also Aetna Cas. & Sur. Co. v. Ply Gem Indus., Inc., 343 N.J. Super. 430, 458-62 (App. Div. 2001)(holding that duty to defend depended on actual proof of damage during an insured’s policy period. Absent such proof, an insurer has the right not to defend and “risk” a duty to reimburse the insured for the costs of defense.) Of course, the Court’s determination in that regard is in direct conflict with the “general rules” that: (a) the duty to defend is broader than the

duty to indemnify and (b) the defense obligation applies to claims that are potentially covered, not only those claims that are actually covered. See e.g., Rosario and Voorhees, supra.

Attempting to soften the blow of its watershed reduction in coverage, the Court stated that its decision was not designed “to free the carrier from its covenant to defend but rather to translate its obligation into one to reimburse the insured if it is later adjudged that the claim was one within the policy covenant to pay.” Id. at 390. The Court also offered policyholders the ability to avoid the blunt impact of the coverage reduction by “waiving” the potential conflict of interest created by an insurer’s reservation of right to deny indemnity coverage and expressly agreeing to an insurer’s offer of defense subject to a reservation of rights. Id. See also Dunne v. Fireman’s Fund American Ins. Co., 69 N.J. 244, 252 (1976)(requiring insurer to fund the defense costs of underlying action if a “conflict” prevented the insurer from assuming control of the defense).

Years later, however, the Appellate Division adopted a different interpretation of the conflict waiver escape mechanism. In The Trustees of Princeton University v. Aetna Cas. & Sur. Co., 293 N.J. Super. 296 (App Div. 1996), certif. granted, 147 N.J. 574 (1997), a policyholder attempted to exercise the “conflict waiver” option in connection with an environmental contamination claim. The policyholder tendered the defense of the claim to its insurer and agreed that the insurer could reserve its right to contest indemnity coverage. The insurer refused the tender, arguing that there was a question whether the policyholder intended the contamination at issue and that resolution of the strict liability claim asserted by the government would not resolve the “intent” issue.

The Appellate Division determined that Burd does not “compel[] an insurer to defend under a non-waiver agreement where the circumstances are conflict-laden with concerns about

the insured's intent..." Princeton, 293 N.J. Super at 307. Moreover, the Appellate Division held that a policyholder may not "unilaterally compel the insurer to provide a defense" merely by agreeing to waive any potential conflict of interest. Id. at 297. Thus, it would seem that Princeton allows an insurance company to avoid providing a defense so long as it raises *any* dispute about coverage.

The incredibly broad scope of the Appellate Division's decision is the likely reason that the New Jersey Supreme Court granted certification to the Princeton matter. Unfortunately for policyholders, the Princeton matter was settled before the Supreme Court's substantive review of the Appellate Division could take place.

A strikingly similar scenario developed a year earlier in Rutgers v. Liberty Mutual Ins. Co., 277 N.J. Super. 571 (App. Div. 1994), certif. granted 140 N.J. 274 (1995). The policyholder pursued insurance coverage for an environmental claim brought by a third party seeking contribution and other damages. Rutgers tendered the claim on the ground that the third party complaint alleged property damage that triggered the insurer's defense and indemnity obligations. Rutgers did not address the conflict waiver issue.

The insurer once again declined the tender, citing unresolved issues of intent vis-à-vis the alleged environmental contamination. The trial court agreed with Rutgers that the third party complaint triggered the insurer's defense obligation and ordered the insurer to reimburse all "post-tender" past defense costs. To account for the potential conflict issue, the trial court ordered the insurer to fund, rather than assume control of, the defense on a prospective basis.

The Appellate Division reversed, citing the Burd Exception. Id. at 578-79. In particular, the Appellate Division held that the underlying action would not resolve all of the coverage

issues raised by the insurer and therefore the duty to defend must be converted to a duty to reimburse if coverage was found in a subsequent action. Id.

Following the Appellate Division's decision, the New Jersey Supreme Court again signaled an interest in evaluating the Burd Exception by granting certification to Rutgers, however, the case was settled before a substantive review by the Supreme Court could take place.

It is important to note that New Jersey courts have not allowed insurers to over-reach in applying the Burd Exception since the Princeton and Rutgers decisions were rendered. For example, in Grand Cove II Condo Ass'n, Inc. v. Ginsberg, 291 N.J. Super. 58 (App. Div. 1996), the Appellate Division held that an insurer may not convert the duty to defend into a duty to reimburse unless and until it identifies: (a) a factual issue that could negate coverage; or (b) a viable conflict of interest. Likewise, in Sands v. CIGNA Prop. & Cas. Ins. Co., 289 N.J. Super. 344, 350 (App. Div. 1995), the court held that an insurer may not manufacture an "illusory" conflict of interest to avoid its defense obligation.

In Voorhees v. Preferred Mut. Ins. Co., 246 N.J. Super. 564, 577 (App. Div. 1991), aff'd 128 N.J. 165 (1992), the Appellate Division rejected an insurer's contention that it had an ethical obligation to refuse a defense where the insurer perceived a difference in its interests and its insured's interests. Moreover, the Appellate Division established an important risk associated with insurers invoking the Burd Exception – a settlement of the underlying claim may lead to a finding of coverage for the defense costs incurred *even if* a trial of the claim would have yielded a different result:

We do not read Burd v. Sussex Mut. Ins. Co., 56 N.J. 394 as requiring a hearing to determine whether [the insured's] acts were intentional or only reckless or negligent. Our Supreme Court in Burd said that in the event that the insurer declines to defend its insured because of a perceived

conflict and a judgment is entered, the carrier may be heard upon the coverage issue in a proceeding under the policy and it will have to reimburse the insured for the cost of the defense if the tort judgment is held to be within the covenant to pay. We need not delve into the question concerning what type of hearing was contemplated by the court. Here the [] suit was settled and no judgment was entered against the insured. Based on the small amount of the settlement, [the insured] can fairly argue that [the] claims, which encompass both intentional and reckless or negligent conduct, were “wholly defeated.” In that situation, the insurer may fairly be required to reimburse the insured for the cost of the successful defense even though the insurer would not have to pay the judgment if the case had gone against the insured on a finding of intentional injury.

Id. at 578 (citations omitted). See also L.C.S., Inc. v. Lexington Ins. Co., 371 N.J. Super. 482, 497 (App. Div. 2004)(holding that when an insurer chooses to disclaim its defense obligation instead of defending under a reservation of rights, the insurer “is not entitled to a hearing to re-litigate [] the issue of whether [the claimant’s] injuries were the proximate result of a negligent or intentional act”).

Rest assured that the debate swirling around the Burd Exception will remain active and hard-fought. Just three short years after the Appellate Division offered policyholders hope that the Burd Exception was losing some of its teeth in L.C.S., another Appellate Division panel reanimated Burd in New Jersey Mfrs. Ins. Co. v. Vizcaino, 392 N.J. Super. 366, 375-76 (App. Div. 2007)(rejecting L.C.S. and holding that, pursuant to Burd, “an insurer’s right to a trial on the coverage issue is preserved if it refuses to defend a complaint asserting both covered and non-covered claims”). Just eight months ago, the Appellate Division held that a policyholder may reject an insurer’s offer of defense subject to a reservation of rights while retaining the ability to secure full coverage for the claim at a future date. See Nazario v. The Lobster House, 2009 N.J. Super. Unpub. LEXIS 1069 at *12 and *21 (May 5, 2009)(holding that if an insurer wishes to control the defense and simultaneously reserve a right to dispute liability, it can do so

only with the consent of the insured” and must, in the reservation of rights letter, “fairly inform the insured that the offer [of defense] may be accepted or rejected”)(citations omitted).

New Jersey still has a long way to go to give true meaning to the maxim that the duty to defend is broader than the duty to indemnify. As long as the Burd Exception remains good law, that maxim simply is not always true in New Jersey.

Apportionment of Defense Costs

New Jersey courts also have eroded the insurer’s defense obligation by permitting insurers to pay only a portion of defense costs when a complaint contains both covered and non-covered counts. See e.g., SL Industries, Inc. v. American Motorists Ins. Co., 128 N.J. 188 (1992); See also Aetna Cas. & Sur. Co. v. Ply Gem Indus., Inc., 343 N.J. Super. 430, 463 (App. Div. 2001).

In SL Industries, the Supreme Court held that apportionment may be permissible if the insurer can identify costs that were incurred for non-covered claims:

The general rule is that when the insurer has wrongfully refused to defend an action and is then required to reimburse the insured for its defense costs, its duty to reimburse is limited to the allegations covered under the policy, provided that the defense costs can be apportioned between covered and non-covered claim. When the defense costs cannot be apportioned, the insurer must assume the cost of the defense for both covered and non-covered claims.

Id. at 214-15.

In adopting that holding, the Supreme Court acknowledged that it was taking a minority view on the scope of the insurer’s defense obligation. Id. at 215. At that time, the Supreme Court believed that the majority of courts deciding this issue did not want to become embroiled in sticky apportionment debates and that such debates would prove to be much ado about nothing:

Courts presume that apportioning costs will be very difficult, and that 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. Those courts implicitly require a greater degree of certainty in determining allocability of costs than is either necessary or fair. 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. The legal system frequently resolves issues involving considerable uncertainty. We presume that the insurer and insured can negotiate a satisfactory settlement that fairly apportions the defense costs.

Id. at 216 (citation omitted).

Ironically, just six years later, the Supreme Court recognized the ineffectiveness of its own defense apportionment standard in Schmidt v. Smith, 155 N.J. 44 (1998). Schmidt was an employment case where the plaintiff alleged mixed causes of action against her former employer and a former supervisor. The employer sought coverage under the employer's liability section of its Workers Compensation policy. The employee-supervision was not covered by that policy. The plaintiff obtained a jury award that failed to indicate how liability was apportioned as between the alleged causes of action or as between the two defendants.

Schmidt presented two apportionment issues. First, what, if any, allocation should be made for the defense costs incurred to defend against the potentially covered and non-covered claims? Second, what, if any, allocation should be made for the defense costs incurred on behalf of the covered employer as opposed to those incurred on behalf of the non-covered employee supervisor.

While continuing to endorse its "no default rule" of SL Industries, the Court held that apportionment was not appropriate in either circumstance. Without any in-depth factual analysis of the claims at issue, the Court concluded that "it is highly unlikely that any portion of [plaintiff's] \$80,000 award was unrelated to her bodily injury claims and would therefore not

qualify as the kind of injury for which [the employer] was statutorily obligated to provide coverage.” Id. at 52, fn. 1.

With respect to the persons insured issue, the Court summarily concluded that apportionment of defense costs was neither feasible nor warranted. Id. at 53. First, the Court noted that the defense costs were not capable of being allocation because the employer and former supervisor shared a common defense i.e., the complaint allegations were totally false. Second, the Court conceded that allocating the defense costs was not necessary because “the portion of the cost of defending the [former supervisor] that was not included within the cost of [the employer’s] defense would have been negligible.” Id.

In 2004, the Appellate Division took a stab at developing factors that should be considered in the defense cost apportionment debate since SL Industries provided no specific guidance on the issue. See Hebela v. Healthcare Ins. Co., 370 N.J. Super. 260, 275 (App. Div. 2004). The Appellate Division began its analysis by noting that “an insurer, by issuing a policy and accepting the required premium, agrees to pay the cost of defending a covered claim but not the cost of defending or prosecuting uncovered claims.” Id. at 274. When a mixed claim is presented, the Appellate Division held that trial courts must undertake the “difficult task” of apportioning defense costs and that “scientific precision is not required, only a fair and reasonable estimate.” Id. at 275-76. Pursuant to Hebela, the factors to be considered for defense cost apportionment are: (a) overlap; (b) context for the allocation dispute; and (c) the burden of persuasion. Id. at 276 - 280.

With respect to “overlap,” the Appellate Division held that policyholders are entitled to the **full benefit** of their defense cost coverage even if some of the costs incurred will benefit both covered and uncovered claims. Id. at 277 (citing Cont’l Cas. Co. v. Bd. Of Educ., Charles

County, 302 Md. 516, 489 A.2d 536, 545 (1985)(“So long as an item of service or expense is reasonably related to defense of a covered claim, it may be apportioned wholly to the covered claim.”)). Thus, any costs that overlap between covered and non-covered claims must be paid in full by the insurer.

With respect to context for the allocation dispute, the Appellate Division held that insurers which provide a contemporaneous defense will receive more consideration and “benefit of the doubt” than insurers that breach their defense obligations with respect to establishing non-covered costs. For example, an insurer that breaches its duty to defend and then contends that the case could have been handled better or more efficiently will not garner any sympathy from the court: “the strategic steps taken by [the insured] in defense of the counterclaim, after [the insurer]’s wrongful default should not be second-guessed if, in hindsight, a more expedient path toward a favorable resolution on the merits was possible. So long as [the insured] took objectively reasonable steps in defending the counterclaim, [the insurer] should be bound to compensate [the insured] for the fair and reasonable costs of those steps.” Id. at 278.

Likewise, the Appellate Division held that there are “consequences for the insurer’s refusal to honor its duty to defend” with respect to the burden of persuasion in an apportionment dispute. In particular, the insurer, not the policyholder, must convince the Court that an apportionment may be made and how the allocation may be accomplished. Id. at 279-80.

Apportionment debates continue to rage on in daily practice. With the guideposts established by SL Industries and Hebela, most policyholders and insureds negotiate a resolution to defense costs disputes. However, disputes can and will continue to find their way into the appellate courts, especially where formulaic approaches are taken to apportionment. See e.g., William H. Hall Co. v. Harleysville Ins. Co. of N.J., Docket No. A-1282-08T2 (Oct. 13,

2009)(remanding case for further apportionment after the trial court's defense cost award based on a ratio of covered and non-covered damage claims was rejected).

Allocation of Defense Costs

In addition to diminishing an insurer's defense cost obligation through apportionment, New Jersey courts also require allocation of defense costs in connection with long term, continuous trigger claims such as environmental or toxic tort claims. See e.g., Universal-Rundle Corp. v. Commercial Union Ins. Co., 319 N.J. Super. 223 (App. Div.), certif. denied 161 N.J. 149 (1999); Muralo v. Employers Ins. of Wausau, 334 N.J. Super. 282 (App. Div. 2000), certif. denied 167 N.J. 632 (2001). As discussed below, this type of allocation may also serve to significantly reduce the defense coverage available to policyholders and is another example where New Jersey's law is out of step with the majority view.

The genesis for this allocation rule is found in the New Jersey Supreme Court's landmark decisions in Owens-Illinois, Inc. v. United Ins. Co., 138 N.J. 437 (1994) and Carter-Wallace, Inc. v. Admiral Ins. Co., 154 N.J. 312 (1998). In each of those cases, the Supreme Court held that insurers involved in long term injury claims must pay only their "fair pro rata share" of the claim. To determine the fair pro rata share, courts are required to develop an allocation model that apportions responsibility among insurers based on their "time on the risk" and in proportion to their "degree of risk assumed." Owens-Illinois, 138 N.J. at 479; Carter-Wallace, 154 N.J. at 327.

Universal Rundle was the first decision to address how the Owens-Illinois/Carter-Wallace allocation construct would apply to the defense obligation. In that case, Universal Rundle was faced with an environmental claim. It pursued coverage from eight different insurers which had sold insurance policies to it during the period of the alleged contamination.

Over time, Universal Rundle settled with all but one insurer. None of the settlement agreements with the other insurers specified whether the settlement payments were being made for defense costs, indemnity costs or some combination of the two. Therefore, at the time of trial, the trial court had to decide whether a defense obligation was owed and, if so, what the scope of the defense obligation was for the non-settling insurer.

The trial court determined that a defense obligation was owed because none of the exclusions relied upon by the insurer applied. Universal-Rundle, 319 N.J. Super. at 241. With respect to the scope of the defense obligation, the trial court held that the lone, non-settling insurer should be saddled with the entire cost of defending the underlying action. The insurer countered that, pursuant to Owens-Illinois/Carter-Wallace, its defense obligation could be no more than 3.41%. Id. at 242. While acknowledging that Owens-Illinois/Carter-Wallace provided guidance on allocation issues, the trial court determined that the Owens-Illinois/Carter-Wallace allocation model was not designed to apply to defense costs in this type of case. Id. at 242-43.

The Appellate Division reversed the trial court's "rough justice" approach to establishing the non-settling insurer's defense obligation. Id. The Appellate Division held that Owens-Illinois/Carter-Wallace created a "presumptive rule" that all liability and defense costs must be allocated based on time on risk and degree of risk assumed:

The judge's novel approach of making [the non-settling insurer] pay only the costs of cleanup and remediation in excess of the settlements while obligating it to pay all defense costs is simply not a method suitably respectful of the Owens-Illinois and Carter-Wallace Courts' directives that allocation must be based on an insurer's time on the risk and degree of risk assumed. We therefore remand this issue for determinations on allocation as required by Owens-Illinois and Carter-Wallace.

Id. at 246 (citations omitted).

One year later, the Appellate Division provided further guidance for the duty to defend long term injury claims in Muralo – and further diluted the coverage available to policyholders for “mixed” claims. Muralo involved another “run of the mill” environmental claim where defense and indemnity coverage was sought and denied by insurers because the claim presented covered and non-covered allegations which, the insurers contended, would not be fully resolved upon the conclusion of the underlying action *i.e.*, the Burd Exception. Following the insurers’ disclaimers, Muralo was left to fend for itself and settled the underlying environmental claim. The settlement did not allocation between covered and non-covered allegations.

Thereafter, Muralo pursued its right to defense and indemnity coverage from the insurers. With respect to the claimed defense costs, the Appellate Division held that recovery could be made *only after* apportionment of the covered and non-covered costs had been made. Muralo, 334 N.J. Super. at 294. Unlike in Hebela, the Appellate Division in Muralo did not expressly impose any “punishment” or presumption against the insurer for disclaiming its defense obligation when later developed facts established coverage for at least a portion of the environmental claim. Id. Instead, the Appellate Division vaguely indicated that settled claims should be viewed “differently” than claims where an insurer contemporaneously honors its defense obligation and then held that an apportionment of defense costs was required on remand. Id. at 294-95.

The practical ramifications of Universal Rundle and Muralo are significant. Long term injury or damage claims often trigger policies in effect years – and sometimes decades – early than when the claim is made against the policyholder. By adopting the Owens-Illinois/Carter-Wallace pro rata allocation method with respect to defense cost coverage, New Jersey courts have made a conscious decision to *reduce* the amount of coverage available for long term injury

and damage claims, notwithstanding the Supreme Court's stated desire in Owens-Illinois to adopt "pro rata" allocation to serve the public good by promoting the "maximization of resources" to address such liabilities. Owens-Illinois, 138 N.J. at 450-51, 470 and 480 (adopting pro rata allocation "make the most efficient use of the resources available to cope with" long term, progressive injury claims). Following Universal Rundle and Muralo, policyholders, not insurers, have been saddled with sole responsibility for shares allocated into years where policies are missing and/or there are insurer insolvency problems. Further, environmental claims routinely include a host of allegations that invite a laundry list of coverage defenses to be asserted by insurers, which ultimately are used as leverage to minimize the costs that may be fairly apportioned into the "covered" category for defense costs purposes.

This is just another example of New Jersey's outlier status with respect to defense cost coverage. Many other states, including Pennsylvania, Ohio, Indiana, Delaware, and Washington, require insurers to provide complete and comprehensive defense coverage for toxic tort and environmental claims. J.H. France Refractories Co. v. Allstate Insurance Co., 626 A.2d 502, 507-08 (Pa. 1993); Goodyear Tire & Rubber Co. v. Aetna Cas. & Sur. Co., 769 N.E.2d 835 (Ohio 2002); Allstate Ins. Co. v. Dana Corp., 759 NE.2d 1049 (Ind. 2001); Hercules, Inc. v. AIU Ins. Co., 784 A.2d 481 (Del. 2001); Am. Nat'l Fire Ins. Co. v. B&L Trucking and Constr. Co., 951 P.2d 250 (Wash. 1998).

In those jurisdictions, policyholders are not required to "participate" in any allocation model associated with assigning responsibility for the long term injury claim. See e.g., See [Air Products & Chemicals, Inc. v. Hartford Accident and Indemnity Co.](#), 707 F. Supp. 762, 771 (E.D. Pa. 1989)(holding that a "carrier that issued a covering policy may not, pursuant to its 'other insurance' provision, allocate liability among other carriers in such a way as to impose

liability on [the policyholder], whether by means of deductibles, retrospective premiums, or side indemnity agreements”); Owens-Corning Fiberglas Corp. v. American Centennial Ins. Co., 660 N.E.2d 770, 795 n.37 (Ohio Ct. Comm. Pl. 1995)(holding that “the other insurance clause cannot be used to impose liability on a policyholder”).

Insurer Use Of Extrinsic Evidence

The most recent example of diminishing defense coverage in New Jersey may be found in connection with the use of extrinsic evidence by an insurer to negate or partially avoid a defense obligation that is clearly established through the underlying complaint allegations. The jury is still out, however, as to whether an insurer may rely on extrinsic evidence to eliminate its defense obligation. As noted above, there are currently two conflicting opinions issued by the Appellate Division that address an insurer’s use of extrinsic evidence. See Polarome International, Inc. v. Greenwich Ins. Co., et al., 404 N.J. Super. 241 (App. Div. 2008), cert. denied 2009 LEXIS 539 (Apr. 21, 2009); W9/PHC Real Estate LP, et al. v. Farm Family Cas. Ins. Co., 407 N.J. Super. 177 (App. Div. 2009).

In Polarome, the policyholder was named as a defendant in a series of toxic tort suits arising out of a chemical product that it distributed. As is typical for those types of cases, the complaints contained very barebones allegations that alleged employment history and exposure to a “toxic” chemical throughout the period of alleged employment. The complaints also alleged significant past, present and expected future ongoing bodily injuries for which substantial damages were claimed.

The policyholder tendered the complaints to all insurers on the risk from the first alleged exposure through the filing of the complaint, or the last date of available coverage for the alleged liability, whichever was later. All of the insurers accepted the policyholder’s tender under a

reservation of rights. Thereafter, the insurers actively participated in the defense of the claims. Through the discovery process in the underlying actions, certain insurers developed information that they believed extinguished their defense and indemnity obligations for the claims. Accordingly, the insurers notified the policyholder that they intended to withdraw from the defense of the underlying actions. The policyholder cried foul as it believed the insurers misused their intimate access to the defense of the underlying actions just long enough to gather information to support a denial of coverage.

The policyholder argued that no New Jersey case law permitted an insurer to use extrinsic evidence to extinguish a defense obligation that existed based on the allegations of the underlying complaints. See Aetna Cas. & Sur. Co. v. Ply Gem. Indus., Inc., 313 N.J. Super. 94, 102 (L. Div. 1997), aff'd in part and rev'd in part, 343 N.J. Super. 430 (App. Div. 2001)(where the complaint triggers coverage, *outside factors cannot be used to defray the insurers duty to defend*).(emphasis added). “The obligation to defend is *fixed* when a complaint is filed against the insured since, as a general matter, the duty to defend is ascertained by comparing the allegations in the complaint with the language of the policy.” Hebela v. Healthcare Ins. Co., 370 N.J. Super 260, 268 (App. Div. 2004) (emphasis added). When the complaint is ambiguous, “doubts should be resolved in favor of the insured and thus in favor of coverage.” Voorhees, 128 N.J. at 173.

Moreover, the policyholder directed the Appellate Division to case law from across the country where courts barred the offensive use of extrinsic evidence by insurers to eliminate a defense obligation. See, e.g., Penney v. Capitol City Transfer, Inc., 707 A.2d 387, 389 (Me. 1998) (“Even though evidence beyond the pleadings may later establish the absence of a duty to indemnify, that evidence is not properly considered in determining the duty to defend.”); Penn-

Am. Ins. Co. v. Disabled Am. Veterans, Inc., 490 S.E.2d 374, 376 (Ga. 1997) (insurer must defend even when allegations in complaint are ambiguous or incomplete); Alaska v. State Farm Fire & Cas. Co., 939 P.2d 788, 792 n.1 (Ak. 1997) (“Extrinsic facts known by the insurer which would defeat the duty to defend are not considered by the court in determining the duty to defend,” although extrinsic facts may trigger defense obligation); Petr-All Petroleum Corp. v. Fireman’s Ins. Co. of Newark, 593 N.Y.S.2d 693, 695 (App. 1993) (“the insurer cannot use extrinsic facts to show that there is no coverage); International Business Machines Corp. v. Liberty Mutual Insurance Co., 303 F.3d 419, 426-27, fn. 4 (2d Cir. 2002)(holding that to allow extrinsic evidence obtained through discovery of the underlying case to negate coverage “would give insurance companies a perverse incentive to delay making a decision whether to defend a suit, in the hopes that extrinsic evidence would emerge showing the claim fell outside the policy’s coverage.”).

Nevertheless, the Appellate Division disagreed entirely with Polarome. As an initial matter, the Appellate Division noted that it “found no language in SL Industries or Burd that supports [the] contention that extrinsic evidence may only be considered to support coverage rather than to prove that claims are not covered by the policy.” Polarome, 404 N.J. Super. at 274. Rather, invoking Burd, the Appellate Division held that insurers may “examine evidence beyond the four corners of the complaint to determine whether the insurer would have any obligation to pay if the claim was successful and if not, then the insurer’s duty to defend the claim may be negated.” Id. at 275. Accordingly, the Appellate Division concluded that the insurers were well within their rights to participate in the defense of the underlying actions, gather information to defeat coverage, and then withdraw from the defense, provided that they timely informed the policyholder that the defense was going to be withdrawn. Id. at 276-77.

A mere four months later, a nearly identical panel of the Appellate Division reached the exact opposite decision regarding insurer use of extrinsic evidence to negate a defense obligation in Farm Family. In that case, a real estate company and its management company (“plaintiffs”) were sued in a slip and fall accident. Plaintiffs had general liability insurance with Zurich. They also asserted additional insured rights under a policy issued by Farm Family to the snow removal company they hired to maintain the property where the accident took place. The complaint alleged that plaintiffs and the snow removal company were all negligent in connection with maintaining the area where the accident occurred.

Farm Family attempted to avoid its coverage obligation to plaintiffs by relying on extrinsic evidence to establish that the snow removal company was not involved in an ongoing operation, as required by the additional insured endorsement, when the accident took place. Moreover, Farm Family contended that extrinsic evidence established that plaintiffs, not the snow removal company, were negligent and caused the damages claimed by the claimant. In particular, Farm Family attempted to rely on an expert report that concluded plaintiffs failed to properly test for ice formation at the accident location and therefore caused the accident. Farm Family also sought to rely on a service contract between plaintiffs and the snow removal company as well as deposition testimony from certain witnesses to establish the scope of intended coverage and negligence-related issues.

The trial court rejected Farm Family’s attempted use of the extrinsic evidence. Rather, the trial court followed all of the general rules that should govern the duty to defend and found that the complaint alleged a claim that was potentially covered under the policy and therefore Farm Family had a duty to defend:

An insurer cannot use facts outside of the complaint to deny a defense where the complaint alleges a potentially covered claim...Even though

facts outside the four corners of the complaint made known to an insurer can give rise to a duty to defend, outside facts are not considered where the complaint alleges an action which is covered under the insurance contract. Thus, insurers must defend suits that allege potentially covered claims even if known outside facts “put the claim outside of insurance coverage.

To determine whether Farm Family has to defend plaintiffs in the Danser action, the Court should compare the allegations in the complaint with the language in the policy. The complaint alleged bodily injury due to plaintiffs and [the snow removal company’s] negligence and carelessness in that they caused and permitted unsafe, dangerous and hazardous conditions and defects to exist on the premises, failed to warn of said dangers among others. The policy provides that Farm Family “will pay those sums that the insured becomes legally obligated to pay” as damages because of “bodily injury,” “property damage,” “personal injury” or advertising injury to which the insurance applies. Further, the policy provides: “We will have the right and duty to defend any suit seeking damages.”

Farm Family has a duty to defendant plaintiffs. The Danser complaint alleges negligence under Farm Family’s policy. The policy is clearly triggered by the allegations in the complaint.

Farm Family, 407 N.J. Super. at 190 (citations omitted).

Notwithstanding its earlier holding in Polarome, the Appellate Division affirmed the trial court’s grant of summary judgment against Farm Family. While recognizing that extrinsic evidence may be used to establish coverage, the Appellate Division held that it may not be used to extinguish a defense obligation:

Extrinsic facts, those outside the complaint, later revealed in discovery, may trigger the duty to defend. However, an insurer must defend if the complaint states a cause of action covered by the policy even if the insurer knows of extrinsic facts which would put the claim outside the insurance coverage. We find no merit in [Farm Family]’s argument. Reference to extrinsic evidence to interpret a contract is irrelevant here because such evidence is not as readily considered in the insurance context, as in the general contract case.

Id. at 192.

The Polarome and Farm Family decisions cannot be reconciled. The Supreme Court denied certification to Polarome and Farm Family did not have a reason to appeal the Appellate Division's decision on the use of extrinsic evidence because it ultimately prevailed in establishing that its policy was excess to plaintiffs' general liability policy with Zurich.

Insurer use of extrinsic evidence to negate a defense obligation will remain a hotly contested issue until the New Jersey Supreme Court makes a determination.

Conclusion

New Jersey has a deceiving reputation as a "pro-policyholder" jurisdiction because it has favorable law on certain coverage issues, such as late notice and the "sudden and accidental" pollution exclusion. However, this article demonstrates that New Jersey law on defense-related issues is far from "pro-policyholder." Indeed, the balance seems to tip in favor of insurers on most decisions evaluating the scope of an insurer's duty to defend.

The New Jersey Supreme Court will have to resolve the conflicting opinions that exist at the Appellate Division level with respect to the Burd Exception where a policyholder "fends for itself," settles a claim and then pursues reimbursement from a disclaiming insurer. Likewise, the Supreme Court will have to make the ultimate call regarding whether insurers should be permitted to use extrinsic evidence to eliminate a defense obligation that is created by the complaint. When those reviews take place, the insurance bar will inundate the Supreme Court with amicus briefs because the Burd Exception and extrinsic evidence issues remain at the forefront of New Jersey insurance coverage practice.