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Covered Events

The Newsletter of the Insurance Law Committee

5/31/2017 2017 Issue 5

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Settlement of Covered and Non-Covered Claims: Assigning and Meeting the Burden of Proof of Allocation

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Unlike commercial general liability or other professional lines insurance, Director & Officer ("D&O") liability insurance policies typically do not contain a duty to defend, but rather a duty to indemnify defense expenses. This difference leaves insurers susceptible to being left in the dark while insureds negotiate and reach settlement agreements with plaintiffs. Of course, D&O liability insurance policies require that insureds cooperate with the insurer in the defense and settlement of a claim and that the insured seek the insurer's consent to settle; but, insureds have been known to breach these conditions to coverage. Sometimes the insurer is asked to consent to a settlement only after a settlement agreement has been reached and the insurer has little to no information about potential liability or exposure, the reasonableness of the settlement and, critically, how the settlement should be allocated between covered and non-covered claims. With this information disparity, it can be difficult for an insurer to establish this allocation on its own.

This article discusses how courts have addressed the question of which party has the burden of proving how much of a settlement should be attributed to covered claims versus non-covered claims, and provides advice on how to persuade the court to place the burden on the insured and how to either rebut the insured's evidence or meet the burden if and when placed on the insurer.

It is axiomatic that the insured has the burden of demonstrating coverage under the insuring agreement, while the insurer has the burden of demonstrating the applicability of an exclusion. *See*, *e.g.*, *Julio & Sons Co. v. Travelers Cas. & Sur. Co. of Am.*, 591 F. Supp. 2d 651, 656 (S.D.N.Y. 2008); *Verticalnet, Inc. v. U.S. Specialty Ins. Co.*, 492, F. Supp. 2d 452, 456 (E.D. Pa. 2007); *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1175 (N.D. Cal. 1994). But what happens once the insured demonstrates that part of a claim is covered and the insurer demonstrates that part of a claim is not? Which party bears the burden of proving *how much* of a settlement was or should be allocated to the covered claim(s) versus the non-covered claim(s)?

An increasing number of courts that have considered this issue recognize that the insured is in a better position to allocate and have placed the burden of allocating between covered and uncovered claims on the insured. *See*, *e.g.*, *UnitedHealth Group Inc. v. Columbia Cas. Co.*, 941 F. Supp. 2d 1029 (D. Minn. 2013) ("[Insured] should bear the burden of proof on allocation, even as to claims that are uncovered because they fall within a policy exclusion."); *Executive Risk Indem., Inc. v. CIGNA Corp.*, November Term, 2004 No. 1495 (Phila. Cty. C.C.P. Nov. 15, 2011) (collecting cases and finding that burden rests with insured who controlled settlement to the exclusion of insurer and noting that its conclusion was consistent with the approach taken by majority of jurisdictions to have considered the issue, including courts applying Texas, California, Hawaii, Massachusetts, West Virginia and Oregon law), *aff'd*, 74 A.3d 179 (Pa. Super. 2013); *Clackamas Cty. v. Midwest Emp'rs Cas. Co.*, No. CV 07-780, 2009 WL 4916364, *10 (D. Or. Dec. 14, 2009) ("Moreover, courts generally place the burden on the insured to allocate settlement between covered and non-covered claims unless the conduct of the parties justifies placing the burden on the insurer."), *aff'd*, 473 F. App'x 782 (9th Cir. 2012); *Piper Jaffray Cos. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 38 F. Supp. 2d 771, 776 (D. Minn. 1999) ("burden of proof and persuasion to demonstrate that costs and payments are related to

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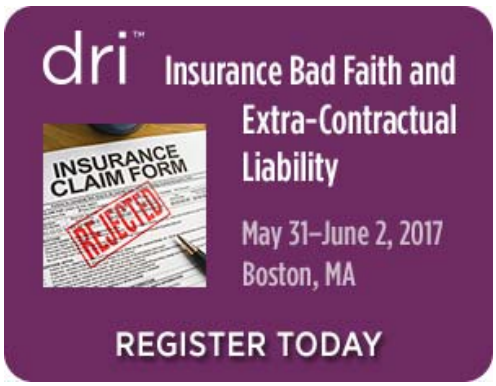

exposure of covered officers and directors rather than the corporate entity lies with the insured"); *Raychem Corp. v. Fed. Ins. Co.*, 853 F. Supp. 1170, 1176 (N.D. Cal. 1994) ("The party seeking coverage must show the existence and extent of a loss covered by the policy.").

Despite the fact that the insured is, more often than not, in a better position to allocate, some courts have nonetheless placed this burden on the insurer. *See PMI Mortgage Ins. Co. v. Am. Int'l Specialty Lines Ins. Co.*, 291 F. App'x 40 (9th Cir. 2008) (unpublished) ("Where the insurer has the burden of proving the lack of coverage, it also has the burden of proving the allocation of the loss between covered and uncovered losses."); *PepsiCo, Inc. v. Cont'l Cas. Co.*, 640 F. Supp. 656, 662 (S.D.N.Y. 1986) ("Evidence of a good faith settlement of the underlying litigation … creates a presumption that the costs are covered by the policy," and the insurer "must accordingly bear the ultimate burden of proving what amount of the settlement cost should be excluded from the policy coverage"); *Health-Chem Corp. v. Nat'l Union Fire Ins. Co.*, 559 N.Y.S.2d 435, 438 (Sup. Ct. NY Cty. 1990) ("Once prima facie proof that an expense was incurred in defense of a covered party has been introduced, the burden of showing that all or a specific portion of it was incurred in defense of a non-covered party, is on defendant.").

Practically speaking, the burden to allocate *should* fairly lie with the party with control over the settlement and access to the relevant information concerning any potential allocation. *Clackamas*, 2010 WL 5391577 at *11 (finding that burden was on insured where insured defended litigation, controlled settlement and agreed to global lump sum settlement with knowledge allocation might be an issue); *Raychem*, 853 F. Supp. at 1176 (noting that "the insured has better access to information relevant to allocation than does its insurer, particularly, as here, where the insured chose counsel for itself and its officers and controlled the defense"); *Executive Risk*, November Term, 2004 No. 1495 ("Where the insured controlled the litigation and knew of the need to allocate, courts have always found that the insured bears the burden of allocating between covered and non-covered claims").

One way to persuade the court that the burden should be placed on the insured is to develop a record -- early and often. Upon learning of a settlement, when requesting liability and damages analyses, expert reports, mediation briefs and the like, ask for the insured's allocation analysis too. Ask the insured whether and the extent to which it has allocated the settlement between covered and non-covered claims and/or between the various causes of action in the complaint. To the extent the insured does not respond or otherwise refuses to provide this information, make a record. Continue asking and do so in writing.

In *United Health*, where the insured negotiated and agreed to the settlement without involving its insurers, the insured did not provide this information despite repeated requests by the insurers. In addition, during discovery, the insured objected to providing any information about how it valued the claims, arguing it was protected by the attorney client privilege and work product doctrine (and would be the subject of expert testimony). As a result, the court found "compelling reasons" to place the allocation burden on the insured:

> United controlled the underlying litigation, and it negotiated the AMA/Malchow settlement. The insurers did not play a meaningful role in those settlement negotiations. For that reason, United is not only in a better position to know how the settling parties valued the claims, but United was able to shape the record on that issue – and to do so at a time when United knew that allocation would almost certainly become a crucial issue in coverage litigation. Despite all of this, United chose not to allocate the settlement. Under these circumstances, it hardly seems fair to force the insurers to bear the burden of proof on allocation.

United Health, 941 F. Supp. 2d at 1036-1037.

Wherever the burden lays, it can be met with contemporaneous evidence of how the claims were valued at the time of the settlement, such as through testimony of the attorneys representing the parties to the settlement or memoranda analyzing the potential exposure for each cause of action. If there is no such evidence, or the insured refuses to produce it on privilege grounds like it did in *UnitedHealth*, experts in litigating the causes of action at issue can be useful in valuing the settled claims. *See UnitedHealth*, 941 F. Supp. 2d at 1034, 1040. The expert should be experienced in handling trials and appeals and settling

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the types of claims that are at issue in the underlying action and, preferably, in the jurisdiction where the underlying action was venued.

This was the type of evidence the court was looking for in *UnitedHealth*, which the insured attempted to provide, but fell short. There, the insured hired an antitrust expert to opine on the value of the purportedly covered antitrust claims in one of the underlying actions that was settled. However, this expert had no experience or expertise in ERISA claims, which were alleged in another underlying action that was also part of the settlement and which the insured conceded were not covered under the policies. The insurers were successful in challenging the expert's qualifications to opine on the ERISA claims under *Daubert*. Without an ERISA expert, the insured was left with no admissible evidence to value the ERISA claims and, thus, was unable to meet its burden of proof. *UnitedHealth Group Inc. v. Columbia Cas. Co.*, 47 F. Supp. 3d 863 (D. Minn. 2014).[1]

While expert evidence is one way of satisfying the burden, at least one court has rejected such evidence. In *PMI*, the district court granted the insured's motion to preclude the insurer from introducing expert testimony regarding the reasons why the underlying parties settled, rejecting his opinions as legal opinions of a hypothetical nature:

> [The expert's] opinion did not rest on any personal experience in the [underlying] action, nor was his opinion based on knowledge that he obtained from acting principles in the [underlying] action. Rather, [the expert's] opinion was of a hypothetical nature, based on the underlying complaints and pleadings on file in the [underlying] action, and on his general – even if substantive- experience in litigating class actions. The court found, and continues to find, that this is an insufficient basis upon which to admit expert testimony.

PMI Mortgage, Ins. v. Am. Int'l Specialty Lines Ins. Co., No. 02-1774, 2007 WL 1864780, *6 (N.D. Cal. June 28, 2007).

In sum, when dealing with settlements of both covered and non-covered claims, it is important to promptly request the insured's allocation analysis, including how the insured allocates the settlement amongst the causes of action, and think about the kind of evidence the insurer will need to meet the burden of proof and rebut the insured's evidence, including experts experienced in litigating the claims at issue.

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[1] *UnitedHealth* is currently on appeal to the Eighth Circuit Court of Appeals.

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