Both Options Now Available on a Variety of Liability Policies

Duty to Pay, Duty to Defend: What's the Difference?

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Several years ago, when the market was harder than it is now, there was not a whole lot of choice when it came to negotiating defense-coverage provisions in liability policies.

Certain policies, such as directors & officers, came with standard "duty-to-pay" provisions -- it was the insured's, not the insurer's, duty to defend a claim and seek reimbursement from the insurer.

Other policies, such as commercial general liability, came with standard "duty-to-defend" provisions -- the insurer had the right and duty to defend any claim seeking damages covered by the insurance.

So much for tradition. Today, defense-cost provisions are negotiable, and even off-the-shelf policies in product lines that were the hallmark of duty-to-pay policies are now available with duty-to-defend provisions.

D&O With Duty to Defend

D&O policies now can be found written on a duty-to-defend basis. One example is EMRA's "Power" form. Swett & Crawford also has been selling a D&O form out of the London market for more than a year that has duty-to-defend provisions.

In addition, more and more "working-layer" employment-practices-liability policies -- those with retentions of $25,000 or less -- are now readily available on a duty-to-pay form, or a hybrid duty-to-pay/duty-to-defend form. AIG and Reliance each have come out with such a form.

Even multimedia liability, typically written on a duty-to-defend form, is now available with duty-to-pay terms. One example is ERMA's Form B25947 (3/98 ed.).

In the last several years, I have heard a lot of hype when it comes to brokers, agents and underwriters explaining the differences between duty-to-defend and duty-to-pay defense-coverage provisions. As this issue becomes increasingly important in several product lines, more and more clients will be asking their agents or brokers to explain the differences between these provisions.

Just as important, agents and brokers should explain to their clients that they might have the choice between duty-to-defend and duty-to-pay provisions in any number of liability policies in their program.

Lest the reader misstate something when he or she explains these issues to a client, I thought this article would prove useful as a basis for understanding the differences between the two coverages.

What Do the Phrases Mean?

The phrase "duty to defend" refers to a liability policy expressly stating that the insurer has the duty to defend any claim alleging something that is covered under the policy -- whether that be covered damages, a covered wrongful act or whatever.

The phrase "duty to pay" refers to a liability policy expressly stating that the insurer does *not* have the duty to defend claims, but rather that it is the duty of the insured to defend claims. The insurer merely has to pay the defense costs in connection with the policyholder carrying out the defense of the claims.

One of the important differences between a duty-to-pay and a duty-to-defend policy is who has the right to choose counsel and control the defense of the claim. Under duty to defend, in most circumstances the insurer has the right to choose defense counsel. The one exception is where the insurer agrees to defend the policyholder in a claim, but subject to a reservation of rights to deny coverage, if that reservation creates a conflict of interest for the defense counsel chosen by the insurer.

In such a case, in many, but not all, jurisdictions in the United States -- Oregon, for example, does not follow this rule -- the policyholder has the right to use counsel of its choice, paid by the insurer, subject to certain restrictions. This is commonly referred to as "independent counsel" (or *Cumis* counsel in California).

Other than in the case of the insurer's obligation to provide independent counsel, the lawyers handling the policyholder's defense can be any attorney(s) chosen by the insurer, even if the policyholder does not know, like or even want the lawyer(s). This also means that, even if the insurer uses a lawyer recommended by the policyholder, the insurer has the right to remove that lawyer from the defense of the claim at any time and put in place another attorney of the insurer's choosing.

In addition, under a duty-to-defend policy, the insurer typically has the absolute, unfettered right to control the defense of the claim. This means the insurer can settle a claim at any time, even if the policyholder does not want to settle. This also means the insurer can refuse to settle a claim and take the claim to trial, even if the policyholder wants to settle.

Insured Chooses Lawyer

By contrast, under a correctly worded duty-to-pay policy, the insured is able to use any lawyer of its choosing. Also, the policyholder is able to control the defense of the claim. This means the policyholder can settle a claim if it wants to settle, or take the claim to trial if the policyholder wants to do so.

The advantage of duty to pay over duty to defend, as some insureds see it, is that the policyholder, not the insurer, is in position to create the "reputation" of the policyholder as to how it handles the type of claims that are subject to the program (whether they be D&O, EPL, media E&O, intellectual-property infringement or whatever other type of claim).

Does the policyholder (a) "throw money" at such claims, regardless of merit, (b) "vigorously resist" frivolous claims by taking all such claims to trial and settle claims that have merit only after thorough investigation and discovery shows the merit of the claim, or (c) take all such claims to trial, regardless of merit and regardless of consequences?

It appears to many a policyholder that only it, not an insurance company, can formulate, implement and monitor its claim-handling strategy to create the "reputation" that the policyholder wants.

Another advantage of duty to pay over duty to defend, as some insureds see it, is the policyholder is assured that the lawyers handling the defense of its claims are not typical insurance defense lawyers, some of whom have divided loyalties between the policy-

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holder and insurer. Divided loyalties are actually imposed by law on defense lawyers under a duty-to-defend program because some state laws provide that the defense lawyer under a duty-to-defend policy has two clients -- the insurer and the policyholder -- and owes fiduciary duties to both.

By contrast, in many jurisdictions, the defense counsel has only one client in duty-to-pay policies -- the insured.

Handling Allocation Issues

Another difference between duty to defend and duty to pay is how the policies respond when a claim is made against both covered and noncovered parties or contains both covered and noncovered claims. When a claim containing noncovered items is made, the insurer will argue that it has the right to allocate defense costs between the covered and noncovered items.

Under a duty-to-defend policy, the insurer has the obligation to defend the entirety of a claim or lawsuit that contains both covered and noncovered items. In other words, the insurer does not have the right to allocate defense costs to noncovered items and refuse to pay for such costs.

However, if California law applies to the policy, the insurer is allowed to reserve its right to seek reimbursement of defense costs after the underlying claim is settled or taken to judgment (or, if applicable, appealed). If the insurer reserves such a right, after the claim is settled or taken to judgment (or, if applicable, appealed), the policyholder is obligated to reimburse the insurer for any defense costs that the insurer can show related solely and exclusively to the defense of noncovered items (i.e., noncovered parties and/or noncovered claims).

Under a duty-to-pay policy, the insurer has the right to allocate defense costs as they are incurred if the claim has both covered and noncovered parties or both covered and noncovered claims. In other words, if the insurer can show an entitlement to allocation at the outset of such a claim, the insurer does not have the obligation to pay for the defense of the entirety of the claim (as it would under a duty-to-defend policy as explained previously).

Costs Solely, Exclusively Relate

In order to demonstrate an entitlement to allocation, the insurer must show what defense costs relate solely and exclusively to the defense of noncovered items (i.e., noncovered parties and/or noncovered claims).

Notice that the allocation standard used for duty-to-pay policies is the same as is used for duty-to-defend policies interpreted under California law. The only difference is the timing of the allocation.

Under duty to pay, the insurer has the immediate right to seek allocation and, therefore, the obligation to pay for covered costs only. Under duty to defend, the insurer does ***not*** have such a right; the insurer must pay for all defense costs if anything in the claim or lawsuit is covered. Under a duty-to-defend policy, only after the claim is resolved, if ever, can the insurer seek reimbursement of certain costs.

But because the allocation standards are the same, there really is only one practical difference between the two types of policies. That difference is cash flow. In a duty-to-defend program, all defense costs for covered and noncovered items are fronted by the insurer, and the policyholder provides whatever reimbursement is due the insurer after the claim is resolved. In a duty-to-pay program, allocation issues can result in covered defense costs being paid by the insurer and noncovered defense costs being paid by the policyholder during the entire tune the claim is pending, from start to finish.

Disclosing Privileged Information

As in any defense of a claim, the defendant does not want the plaintiff to have access to the thoughts, communications and work product of the defendant's lawyer. A plaintiff is not entitled to such information because of two very important protections -- the attor-

ney-client privilege, which protects communications between the attorney and client, and the attorney-work-product doctrine, which protects the attorney's thoughts and own work.

If the plaintiff is able to obtain such information, such as what the attorney really thought of plaintiff's case, severe prejudice against the defendant would result.

When a claim is covered by liability insurance, a third party, the insurer, is added into the relationship between lawyer and client. What happens when the policyholder's lawyer discloses information to the insurer?

Under the laws of most states, if not every state, disclosure of information by the attorney to the insurer acting under a duty-to-defend policy does not serve as a waiver of the attorney-client privilege and attorney-work-product doctrine. Therefore, the plaintiff is not entitled to the information by reason of the disclosure to the insurer.

However, this protection is not as well-developed when the insurer is acting under a duty-to-pay policy. Only a handful of states have addressed this issue in any detail. In some states, courts have concluded that disclosure by the policyholder's attorney to the insurer under a duty-to-pay policy acts as a waiver of all protections attaching to the information disclosed. That means the claimant is entitled to the information if the claimant seeks it.

In some other states, however, courts have concluded that such a waiver makes no sense, and have applied the same rules that relate to duty-to-defend policies. That means the claimant is not entitled to the disclosed information.

Assume Protections Waived

In those jurisdictions where the issue has not been resolved, it is prudent to operate under the assumption that disclosure of privileged information to a duty-to-pay insurer does, indeed, waive the protections. Thus, the protocol that should be used is as follows:

* The insurer hires "monitoring" counsel.

* The policyholder's counsel provides to the insurer and the insurer's monitoring counsel only publicly available information -- pleadings, discovery, etc.

* The monitoring counsel formulates its own ideas about the case and advises the insurer. The insurer also has the right to have the monitoring counsel associate itself in the defense of the case, again to help keep the insurer apprised of developments.

By following this procedure, the policyholder can avoid the risk of waiving a protection and allowing the claimant to get his/her hands on sensitive information that could be very prejudicial to, if not disastrous for, the policyholder.

No One Right Answer

As more and more lines of coverage offer policy options containing duty-to-defend, duty-to-pay and hybrid duty-to-defend/duty-to-pay defense-coverage provisions, it becomes increasingly important for agents and brokers to know the differences between the types of coverage available.

There is no one right answer for all policyholders on this issue. The decision that each policyholder will make will be based on several variables, including personal taste.

The best result that I believe can be obtained is that the policyholder makes an informed decision on which type of program it wants, regardless of product line at issue. Therefore, agents and brokers need to be well-versed on these issues in order to help their clients make an informed decision.

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