

NJ Broadens Insurers' Duty To Defend

Law360, New York (October 29, 2010) -- In an important recent decision for policyholders, the New Jersey Supreme Court made clear that an insurer's reservation of rights will not strip the policyholder of the broad duty to defend promised in traditional liability insurance policies.

In what could be viewed as a de facto reversal of a 40-year-old New Jersey position on defense coverage, the high court ordered the liability insurer to provide a defense to an underlying tort case against its insured, even though the ultimate question of indemnity coverage could not yet be decided.

The decision brings New Jersey's approach to the duty to defend into harmony with the majority rule in other jurisdictions.

The underlying liability in *Flomerfelt v. Cardiello*, 997 A.2d 991 (N.J. 2010), stemmed from a party that defendant Cardiello hosted at his parents' home when they were out of town.

Plaintiff Flomerfelt alleged that while at the party she suffered bodily injury, which could have been due to her ingestion of alcohol, or of drugs, or of both in combination, or it could have been due to Cardiello's alleged delay in calling for help when he found her the day after the party and she was unresponsive.

Cardiello tendered the defense to his parents' homeowners insurer, which denied coverage based on an exclusion for claims "[a]rising out of the use ... transfer or possession' of controlled dangerous substances." *Flomerfelt*, 997 A.2d at 995 (quoting the policy) (alteration in original). Cardiello sued the insurer for declaratory relief, and the coverage case was consolidated with the personal injury action — which explains why no insurer appears in the short form of the case name.

The Supreme Court reasoned that *Flomerfelt's* complaint alleged potentially covered liability. Specifically, if the trier of fact were to determine that alcohol ingestion at the party caused *Flomerfelt's* injuries, perhaps in combination with the alleged delay in summoning help, then there could be liability within the coverage grant of the policy and not within the exclusion for controlled substances.

On the other hand, the complaint also alleged liability that would be excluded: if the trier of fact were to determine that *Flomerfelt's* injuries were substantially caused by use of illegal drugs at the party, any liability would fall within the exclusion.

What happened next is what makes the case so important for New Jersey insurance law. The court concluded that "[t]he duty to defend ... is not dependent upon whether there is a finding that the claim is covered; instead it attaches because our analysis of the exclusion demonstrates that there are potentially covered claims." *Id.* at 1006.

In most states, this would be unremarkable. In the majority of jurisdictions, so long as a complaint creates the possibility of a covered liability, a primary insurer that has promised to defend the insured is obligated to defend the lawsuit from the outset, even if there is also the possibility of liability that would not be covered.

But for the last 40 years, New Jersey duty-to-defend law has been guided by *Burd v. Sussex Mutual Insurance Co.*, 267 A.2d 7 (N.J. 1970), which had the unfortunate practical effect of shrinking the insurer's duty to defend so that it was deemed to be coterminous with the duty to indemnify in cases in which the insurer's reservation of rights created a conflict of interest with the insured concerning the defense of the tort action.

In *Burd* the Supreme Court was concerned that an insurer conducting the insured's defense under a reservation of rights might be able to steer the case in a manner that was detrimental to the insured but favorable to the insurer.

For example, if a two-count complaint alleged both that a given injury was caused negligently and that it was caused intentionally, an insurer that was controlling the defense could serve its own interests by mounting a less-than-vigorous defense to the intentional-injury count, leaving the insured exposed to liability that was outside the coverage.

The court in *Burd* held that in such a circumstance, the insurer had the option of leaving the policyholder to defend the claim by itself; then if at the end of the case covered liability was imposed, the insurer would reimburse the insured's defense costs.

Although the *Burd* rule solved the fox-in-the-henhouse problem, it did so at a drastic cost, namely, by substantially eroding the value of the liability policy's defense coverage.

Instead of providing defense coverage that was far broader than the indemnity coverage (as is intended in standard primary liability policies), insurers after *Burd* could effectively equate their defense coverage with their indemnity coverage, in cases in which the insurer's reservation of rights would create a conflict of interest for defense counsel controlled by the insurer. In such cases, defense coverage would apply only if indemnity coverage applied.

To make matters worse, the coverage issue would not be resolved until the underlying tort action had concluded, meaning the policyholder was forced to fund its own defense of the tort case and then the resolution of a coverage case.

The conflict-of-interest problem that *Burd* tried to address is a real one.

However, most states have addressed this issue in a manner that is more pragmatic and that protects the insured's broad defense coverage.

Specifically, they require the insurer to cede control of the defense to the insured, converting the duty to defend into a duty to reimburse the defense costs incurred by independent counsel. See, e.g., *San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.*, 208 Cal. Rptr. 494 (Cal. Ct. App. 1984); *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810 (NY 1981).

In this fashion, defense counsel's allegiance to the client — the insured — is safeguarded, and the insured retains the substantial defense benefit that it purchased as part of its insurance.

For some time, the *Burd* rule has appeared to be at risk. At least twice the New Jersey Supreme Court accepted review of a case that would have put the continuing validity of *Burd* squarely before the court (once in a case involving Rutgers University and once in a case involving Princeton University). Each time, however, the case was settled before the court could issue a ruling.

To be sure, the court in *Flomerfelt* did not expressly overturn *Burd*. Indeed, the court discussed *Burd* at some length, even describing *Burd*'s grant of permission to the insurer to "refuse to defend and dispute its obligations thereafter, so as 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.'" *Flomerfelt*, 997 A.2d at 999 (quoting *Burd*, 267 A.2d at 10).

The court appeared to view Flomerfelt as merely an alternative procedural option mentioned in Burd: ““a declaratory judgment proceeding ... brought in advance of [the underlying] trial by the carrier or the insured, to the end that the third-party suit may be defended by the party ultimately liable.”” Id. (quoting Burd, 267 A.2d at 11).

Despite the court’s apparent effort to reconcile Flomerfelt procedurally with Burd, however, the two decisions cannot be reconciled substantively.

Indeed, it is hard to see how the Burd rule can ultimately survive the Flomerfelt court’s key holdings. In Flomerfelt the court made clear that the duty to defend does not depend upon an ultimate finding that the claim is covered, and that instead the duty attaches so long as the suit presents a potentially covered claim.

The court also made clear that the duty is not negated by the presence of noncovered claims. Perhaps most importantly, the court held that “in circumstances in which the underlying coverage question cannot be decided from the face of the complaint, the insurer is obligated to provide a defense until all potentially covered claims are resolved.” Id.

The rule that the insurer must provide a defense so long as even one potentially covered claim remains in the case cannot be squared with a rule that says that defense coverage applies retroactively, and only after a finding that there is, in fact, indemnity coverage.

Flomerfelt at last aligns New Jersey with the vast majority of other jurisdictions by preserving the standard liability policy’s broad defense obligation, even in cases where the insurer disputes its indemnity coverage.

As such, this decision appears to sound the death knell for Burd’s defense-denying solution to the fox-in-the-henhouse problem.

In addition, a right of independent counsel in New Jersey cases where the insurer’s reservation of rights creates a conflict of interest for insurer-appointed defense counsel — a right that currently exists for insureds in most other states — would logically follow from the demise of Burd.

From this point forward, policyholders whose coverage rights are governed by New Jersey law should invoke Flomerfelt in order to ensure that they obtain the broad defense coverage that is afforded them under their liability policies.

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