NAVIGATING DISPUTES OVER ALLOCATION BETWEEN COVERED AND UNCOVERED CLAIMS

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I. INTRODUCTION—THE RECURRING COMPLICATION OF ALLOCATION BETWEEN COVERED AND UNCOVERED CLAIMS

Policyholders who find themselves on the receiving end of a lawsuit universally have the same question for their lawyers: "Does our insurance cover this?" Coverage lawyers, whether on the policyholder or insurer side of the fence, know this question rarely has a simple "yes or no" answer. Many underlying lawsuits—particularly commercial litigation of any complexity—include some claims that are clearly covered and some that are not. Common fact patterns include:

- A lawsuit against a professional—lawyer, architect, or engineer—that asserts garden-variety claims of professional negligence, but also alleges overbilling and fraud.
- A consumer class action against a service provider that alleges potentially covered claims for negligence, but also seeks excluded punitive damages and damages that may fall within the "return of profit or advantage" exclusion from D&O coverage.
- A lawsuit against an insured corporation, along with co-defendants—individuals or affiliated businesses—that are not insured. However, the interests of all the defendants are aligned and all are represented by the same counsel.
- An environmental contamination suit against an insured property owner, who then asserts counterclaims and third-party contribution

claims against other neighbors and predecessor owners who contributed to the contamination.

Often, the uncovered nature of certain of the causes of action is not disputed; some claims, such as a claim for fraud that is tied to a plaintiff's verdict, simply are not covered. The source of frequent disputes in such "mixed" actions instead is over the practical effect of the presence of uncovered claims—that is, under what circumstances may costs be allocated to the uncovered claims, therefore to be borne by the insured? The conflict can arise both with respect to defense costs and liability resulting from a settlement agreement or judgment.

The law governing allocation between covered and uncovered claims or entities—including whether allocation is permitted at all, who bears the burden of proof if it is, and what methods insurers may use to seek allocation—varies substantially among the states. Further, in recent years, insurers have increasingly introduced policy terms that expressly address allocation of coverage in mixed actions. This paper summarizes the competing approaches in the courts, examines the emerging policy terms addressing allocation, and discusses practical strategies for coverage counsel faced with allocation disputes.

II. ALLOCATION OF DEFENSE COSTS

A. *General Rule: No "Real-Time" Allocation of Defense Costs Between Covered and Uncovered Claims*

Courts in most jurisdictions have adopted a per se rule that the insurer must provide a complete defense in a mixed action against the insured.[1]

A small minority of jurisdictions give insurers at least a potential to allocate defense costs to uncovered claims and thereby pay less than the full cost of the defense on an ongoing basis, (i.e., during the pendency of

1. *See* First Newton Nat. Bank v. Gen. Cas. Co. of Wis., 426 N.W.2d 618, 630 (Iowa 1988) ("We think the majority rule is the better one. It assures that the insured will have a coherent, coordinated defense aimed at defeating all of the claims, rather than separate defenses that might work at cross purposes, since the insurer will be interested primarily in defeating the covered claims."); Presley Homes, Inc. v. Am. States Ins. Co., 90 Cal. App. 4th 571, 575 (2001) ("It is settled that where an insurer has a duty to defend, the obligation generally applies to the entire action, even though the suit involves both covered and uncovered claims, or a single claim only partially covered by the policy."); Fire Ins. Exch. v. Bentley, 953 P.2d 1297, 1300 (Colo. App. 1998) ("If the underlying complaint asserts more than one claim, a duty to defend against all claims asserted arises if any one of them is arguably a risk covered by the pertinent policy."); Category 5 Mgmt. Grp., LLC v. Companion Prop. and Cas. Ins. Co., 76 So. 3d 20, 23 (Fla. Dist. Ct. App. 2011) ("If the complaint alleges facts partially within and partially outside the coverage of the policy, the insurer is obligated to defend the entire suit."); Steven Pitt, Daniel Maldonado, Joshua D. Rogers & Jordan R. Plitt, 14 Couch on Insurance § 200:25 n.2 (3d ed. 2018) (collecting cases).

the underlying claim). New Jersey law is the most insurer-friendly on this point.[2]

The State of Washington theoretically allows insurers to provide less than a full defense in mixed actions. In *Bordeaux, Inc. v. American Safety Insurance Co.*,[3] Washington's intermediate appellate court held that "[n]o right of allocation exists for the defense of non-covered claims that are reasonably related to the defense of covered claims."[4] However, the "reasonably related" test means that the right of allocation can rarely be actually invoked. It is difficult to imagine a case in which the various causes of action against the insured are so varied or unrelated that the associated defense costs not be "reasonably related."

B. *Not So Fast: Jurisdictions Requiring Full Defense of Mixed Actions, but Allowing Post-Claim Recoupment of Certain Defense Costs*

The group of issues that has come to be identified by the term "allocation" is most often thought of as arising in "real time," that is, during the pendency of the underlying case. However, a number of jurisdictions—probably a narrow majority—have adopted a rule that permits allocation of defense costs, but shifts the timing of that allocation to after the conclusion of the underlying action. In these jurisdictions, the insurer must defend the entire mixed action, but retains a right to seek recoupment of defense costs associated with uncovered claims. This outcome is essentially a compromise position:

- The policyholder gets the benefit of a full defense but may have to face a recoupment claim at the end of the underlying case;
- The insurer must defend even potentially uncovered claims, but retains a right to allocate to the policyholder at the end of the day (meaning the insurer "fronts" defense costs and faces the risk that the policyholder will be unable to repay any defense costs, no matter how strong the recoupment claim might be).

The seminal decision allowing recoupment of defense costs[5] is that of the Supreme Court of California in *Buss v. Superior Court*.[6] In *Buss*, the

2. Passaic Valley Sewerage Comm'rs v. St. Paul Fire & Marine Ins. Co., 21 A.3d 1151, 1162–63 (N.J. 2011) ("When a complaint includes both covered and uncovered counts the carrier may refuse defense on the uncovered counts and dispute coverage."); *see also* Pitt et al., *supra* note 1, at n.3 (collecting cases).

3. 186 P.3d 1188, 1193 n.20 (Wash. Ct. App. 2008).

4. *Id.* (citation omitted) (internal quotations omitted).

5. The law under discussion in this section addresses whether an insurer may recoup defense costs where the insurance policy at issue contains no term expressly allowing recoupment. Insurers are increasingly including such terms in D&O and other liability policies. *See infra* Section II.E.

6. 939 P.2d 766 (Cal. 1997).

court attempted to strike a balance between preserving the value of the duty to defend, on the one hand, while avoiding imposing on the insurer an obligation that is absent from the insurance contract. The court first explained that the insurer's strict contractual obligation to defend does not extend to uncovered claims; rather, California's rule requiring the insurer to defend a mixed action in its entirety is extracontractual:

> We cannot justify the insurer's duty to defend the entire "mixed" action contractually, as an obligation arising out of the policy, and have never even attempted to do so. To purport to make such a justification would be to hold what we cannot—that the duty to defend exists, as it were, in thin air, without regard to whether or not the claims are at least potentially covered. As stated, the duty to defend goes to any action seeking damages for any covered claim. If it went to an action *simpliciter*, it could perhaps be taken to reach the action *in its entirety*. But it does not. Rather, it goes to an action *seeking damages for a covered claim*. It must therefore be read to embrace the action *to the extent that it seeks such damages*. So read, it accords with the general rule . . . that the insurer has a duty to defend as to the claims that are at least potentially covered, but not as to those that are not . . . .
>
> That being said, we can, and do, justify the insurer's duty to defend the entire "mixed" action prophylactically, as an obligation imposed by law in support of the policy. To defend meaningfully, the insurer must defend immediately. To defend immediately, it must defend entirely. It cannot parse the claims, dividing those that are at least potentially covered from those that are not. To do so would be time consuming. It might also be futile: The "plasticity of modern pleading" allows the transformation of claims that are at least potentially covered into claims that are not, and vice versa.[7]

The court went on to balance this extracontractual benefit to the policyholder by granting the insurer a right to seek recoupment of defense costs after the conclusion of the case:

> As to the claims that are at least potentially covered, the insurer may not seek reimbursement for defense costs . . . . As to the claims that are not even potentially covered, however, the insurer may indeed seek reimbursement for defense costs.
>
> The reason is this. Under the policy, the insurer does not have a duty to defend the insured as to the claims that are not even potentially covered. With regard to defense costs for these claims, the insurer has not been paid premiums by the insured. It did not bargain to bear these costs. To attempt to shift them would not upset the arrangement. The insurer therefore has a right of reimbursement that is implied in law as quasi-contractual, whether or not it has one that is implied in fact in the policy as contractual.[8]

7. *Buss*, 939 P.2d at 774 (citation omitted) (emphasis in original).
8. *Id*. at 776 (citations omitted).

The standard for determining what defense costs may be recouped has limited the practical impact of *Buss* recoupment claims. The court held that the insurer may recoup "[d]efense costs that can be allocated solely to the claims that are not even potentially covered."[9] The "solely" standard often will require a highly fact-driven analysis of defense tasks that may, in practice, have related to multiple claims in the mixed action. The insurer, as the party desiring relief, must carry the burden of proving which claims relate solely to claims that are not even potentially covered.[10]

Other jurisdictions, whether adopting the precise reasoning in *Buss* or otherwise, allow post-defense recoupment of defense costs.

On the other hand, jurisdictions ruling in favor of the policyholder and denying recoupment typically cite some or all of the following grounds:

- Most policies contain no term specifically allowing reimbursement of defense costs.
- That being the case, as a matter of basic principles of contract, insurers cannot unilaterally modify and change policy terms in a reservation of rights letter.
- Recovery in unjust enrichment is unwarranted because the insurer undertakes the defense of the insured to protect itself as much as it is protecting the insured.[11]

C. *Allocation Between Covered and Uncovered Entities That Are Jointly Represented*

Most of the case law on allocation of defense costs concerns actions involving covered and uncovered causes of action against a clearly insured defendant. However, a not-uncommon variant of the allocation debate can arise where an insured defendant has co-defendants that are not insured but

9. *Id.* at 777.

10. *Id.* at 778.

11. *See*, *e.g.*, Westchester Fire Ins. Co. v. Wallerich, 563 F.3d 707 (8th Cir. 2009) (Minnesota law: recoupment of defense costs can only occur if such a right is expressly identified in the insurance policy; a reservation of rights can only retain defenses); Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am., 448 F.3d 252 (4th Cir. 2006) (Maryland law: to allow recoupment would improperly narrow an insurer's broad duty to defend); General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co., 828 N.E.2d 1092 (Ill. 2005) (unilateral reservation of rights by insurer cannot create rights not contained in insurance policy; no unjust enrichment either because insurer defends to protect itself at least as much as it is protecting the insured); Shoshone First Bank v. Pac. Emp. Ins. Co., 2 P.3d 510 (Wyo. 2000) ("no indication in the policy of any distinction to be made between covered and non-covered claims so far as the defense of those claims is concerned, and we will not permit the policy to be modified by subsequent letters from the insurer to the insured"); Nat'l Sur. Corp. v. Immunex Corp., 297 P.3d 688 (Wash. 2013) ("Disallowing reimbursement is most consistent with Washington cases regarding the duty to defend, which have squarely placed the risk of the defense decision on the insurer's shoulders.").

share a common interest with the insured defendant and are represented by the same defense counsel as the insured defendant. In such cases, the policyholder may argue that no defense costs are allocable to the uncovered defendants.

The decision of the U.S. District Court for the Southern District of New York in *High Point Design, LLC v. LM Insurance Corp.*[12] addressed this fact pattern, and the decision provides a useful survey of the applicable case law. The insured and insurer in that case agreed that defense costs that were incurred "solely in defense of" the uninsured parties were not covered (a concession that not all insureds would make, depending upon the jurisdiction). The battleground in the case instead was over the category of defense costs that were not "solely" attributable to the non-insured defendants, but rather "redounded to the benefit of both" the insured and uninsured entities.[13] The insured argued that such costs were entirely covered, and the insurer argued that such costs should be allocated on a pro rata basis among the four benefited parties (i.e., the insured defendant and the three non-insured co-defendants.)[14]

After surveying the case law in support of both positions, the court observed that the insured had "the support of more and better-reasoned case law."[15] The court held, first, that because the insured had made a prima facia showing that the costs in question were incurred, at least in part, to benefit the defense of the insured, the burden of allocation away from the insured fell on the insurer.[16] Second, the court rejected pro rata allocation, in favor of a fact-specific "but for" analysis:

> The amount that should be allocated to the non-covered parties, and thus not recouped from the insurer, are any additional expenses which would not have occurred but for the inclusion of the non-covered defendants.[17]

The court concluded by suggesting that the insurer might have a right of contribution against the non-insured entities or their insurers; any such claims would not reduce the coverage afforded to the insured party: "there is no support in precedent or logic by which an insurer's obligation to defend its insured is steadily diminished as the insured's opponent in the underlying action adds parties to the insured's side of the caption."[18]

12. No. 13-cv-7878, 2016 WL 426594 (S.D.N.Y. Feb. 3, 2016).
13. *Highpoint Design*, 2016 WL 426594, at *3.
14. *Id.*
15. *Id.*
16. *Id.* at *4.
17. *Id.* (internal quotation omitted).
18. *Id.*

D. *Can the Costs of Related Counterclaims and Third-Party Claims Constitute Defense Costs? If Not, Are Such Costs Allocable to the Insured?*

Another variant of the allocation debate involves situations in which the insured defendant seeks coverage for the costs of prosecuting affirmative claims, that is, counterclaims or third-party claims related to the original action. Insurers typically take the position that the costs of pursuing such affirmative claims are not covered because they are not, literally, the costs of defending against a claim. What appears to be a majority of the courts that have squarely considered the matter have adopted this position.[19]

Yet policyholders counter that, in many cases, the assertion of counterclaims or third-party claims is fundamentally defensive in nature in that its affirmative claims are related to the covered defense and designed to offset the original defendant's liability, which benefits the defense effort. Many courts have accepted that view.[20] The rationale of such decisions is typified by that of the court in *Potomac Electric Power Co. v. California Union Insurance Co.*:[21] the effective defense of covered claims often entails asserting counterclaims, and thus the duty to defend obligates the insurer to bring any claim that a reasonable defense attorney would bring.[22]

Because of the benefits of spreading the liability to co-parties, insurers sometimes agree to fund the cost of such affirmative claims for practical reasons, regardless of the state of the law. If no such agreement is reached, and the governing law does not require that the costs of affirmative claims be covered, the result is another type of mixed claim and, therefore, an allocation debate.

E. *Policy Terms Expressly Addressing Apportionment of Defense Costs*

The rules governing apportionment of defense costs by and large have been developed by the courts applying the plain language of the insuring agreement and the "Supplementary Payments" term, and first principles. That is, insurers typically have not employed policy terms that expressly address allocation in mixed claims.

19. *See* Aldous v. Darwin Nat'l Assurance Co., 851 F.3d 473, 483 (5th Cir. 2017) (applying Texas law) (holding no duty to prosecute helpful or inextricably intertwined affirmative claims); Shoshone First Bank v. Pac. Emp. Ins. Co., 2 P.3d 510, 516 (Wyo. 2000) ("We accept the general premise that '[a]n insurer, being obligated to defend claims "against" the insured, is not required to bear the cost of prosecuting a counterclaim on behalf of the insured.'"); Mount Vernon Ins. Co. v. Visionaid, Inc., 76 N.E.3d 204, 209–10 (Mass. 2017) (collecting cases).

20. *See Visionaid*, 76 N.E.3d at 210 (citing cases).

21. 777 F. Supp. 980, 984 (D.D.C. 1991).

22. *See also* Great W. Cas. Co. v. Marathon Oil Co., 315 F. Supp. 2d 879, 882 (N.D. Ill. 2003) (applying Illinois law) (requiring insurer to fund, as cost of defense, affirmative counterclaims that would reduce insured's liability on underlying claim).

The principal exception has been D&O policy forms, most of which for many years have included a term expressly addressing allocation. A typical example is the following, from a form currently in use by one insurance company:

> C. Solely with respect to all Liability Coverage Parts:
>
> If **Loss** is incurred that is partially covered and partially not covered by this Policy, either because a **Claim** made against the **Insureds** includes both covered and uncovered matters or because a **Claim** is made against both covered and uncovered parties, such **Loss** shall be allocated as follows:
>
> (1) 100% of **Costs of Defense** shall be allocated to covered **Loss**; and
>
> (2) **Loss** other than **Costs of Defense** shall be allocated between covered and non covered **Loss** based upon the relative legal exposure of the parties to such matters.

The above provision thus expressly requires full defense coverage of mixed claims but allows allocation of indemnity coverage, under a broad, "relative legal exposure" (perhaps a dressed-up term for "rough justice") standard.

Over roughly the last decade, the authors have increasingly encountered policy terms that depart from this traditional distinction between defense and indemnity coverage for mixed claims. The following example comes from a D&O policy in a form that defines "Loss" as including "Defense Costs":

> XII. ALLOCATION
>
> A. If a Claim includes both Loss that is covered under this Policy and loss that is not covered under this Policy, either because the Claim is made against both Insureds and others, or the Claim includes both covered allegations and allegations that are not covered, the Insureds and the Insurer shall allocate such amount between covered Loss and loss that is not covered based upon the relative legal and financial exposures and the relative benefits obtained by the parties. The Insurer shall not be liable under this Policy for the portion of such amount allocated to non-covered Loss.
>
> B. If there is an agreement on an allocation of Defense Costs, the Insurer shall advance, on a quarterly basis, Defense Costs allocated to Loss. If there can be no agreement on an allocation of Defense Costs, the Insurer shall advance on a quarterly basis Defense Costs which the Insurer believes to be covered under this Policy until a different allocation is negotiated, arbitrated or judicially determined.
>
> C. Any negotiated, arbitrated or judicially determined allocation of Defense Costs on account of any Claim shall be applied retroactively to all Defense Costs on account of the Claim, notwithstanding any prior advancement to the contrary. Any allocation or advancement of Defense Costs on account

> of any Claim shall not apply to or create any presumption with respect to the allocation of other Loss on account of the Claim or any other Claim.

Similar terms, allowing allocation of defense costs in accordance with the relative exposure posed by the covered and uncovered claims, are increasingly common in D&O and Employment Practices Liability forms.

Further, insurers are beginning to introduce similar terms even into General Liability (GL) forms. In the wake of the decision of the Washington Supreme Court rejecting recoupment of defense costs,[23] several insurers began including the following endorsement in GL policies issued to Washington insureds:

> WASHINGTON CHANGES – DEFENSE COSTS
>
> If we initially defend an insured or pay for an insured's defense but later determine that none of the claims, for which we provided a defense or defense costs, [is] covered under this insurance, we have the right to reimbursement for the defense costs we have incurred.

The insurer's ability to recoup defense costs at the conclusion of an underlying claim, under the rule established in the seminal California case *Buss v. Superior Court*, is closely related to the allocation issues that are the subject of this paper. Where an insurer is permitted to recoup costs paid in the defense of claims that are later determined to have been uncovered, the result essentially is a post-underlying claim allocation debate; the only difference is that the insurer will have advanced all of the defense costs, so that the insured need not bear any allocated share during the pendency of the underlying case.

In some jurisdictions, including Washington, the case law regarding the duty to defend suggests that the breadth and independence (from the duty to indemnify) of the duty to defend rises to the level of a matter of public policy. Such case law has given rise to policyholder arguments that policy terms requiring allocation of defense costs to uncovered claims—whether that allocation takes place "in real time" during the underlying case or afterward via *Buss*-style recoupment—are unenforceable as contrary to public policy. The above-quoted "Washington changes" endorsement recently survived a public policy challenge in federal court in Seattle, in *Massachusetts Bay Insurance Co. v. Walflor Industries, Inc.*[24]

Regardless of the outcome of that rather rarified debate, policyholders would be well advised to be aware of what policy form they are purchasing. If they purchase a form that allows defense costs to be allocated—that is, not paid in full—they should do so with their eyes open, understanding

23. Nat'l Sur. Corp. v. Immunex Corp., 297 P.3d 688 (Wash. 2013) (rejecting *Buss*-type recoupment of defense costs under Washington law).

24. No. C18-0791JLR, 2019 WL 1651659 (W.D. Wash. Apr. 17, 2019).

that relatively modest savings of premium dollars may come at a hefty price in the event that the insured becomes a defendant in a mixed claim.

F. *Practical Strategies for Coverage Counsel*

Counsel evaluating a mixed lawsuit asserted against his or her client should keep in mind the following practical points and strategies:

- Carefully review existing coverages for apportionment language. As discussed above, policies increasingly contain terms expressly addressing allocation, and, for the most part, with respect to the duty to defend, allocation terms favor the insurer, particularly in jurisdictions with more policyholder-friendly common law. If allocation terms appear in the policy, counsel should evaluate whether the term is subject to challenge on public policy or other grounds. Further, coverage counsel typically gets involved only after a dispute has arisen under an existing policy. However, the increasing use of policy terms expressly allowing allocation of defense costs presents an opportunity for counsel to add value at the time of placement or renewal. Policyholders should seek to strike such terms, or select one that expressly provides for a complete defense in mixed cases.
- If a claim arises, be aware that most sophisticated claims professionals recognize the importance of mounting an effective defense to the underlying case as a whole (and, in many cases, that the insured might be unable to contribute meaningfully to the cost of the defense). Further, most insurers with a duty to defend, particularly under financial-lines coverages such as D&O, professional liability, and EPL, understand there is a strong presumption against allocation of defense costs to the insured. Policyholder counsel and underlying defense counsel therefore should ensure that the claims professional understands the relationship between the covered and uncovered claims, and understands how defense of the whole suit, including uncovered claims, may benefit the defense of the covered claims.
- For all these reasons, policyholder counsel should discourage or preempt requests by the insurer that defense counsel establish separate billing matters or otherwise attempt to allocate defense costs in a manner that would be contrary to the governing legal standard.

III. ALLOCATION OF INDEMNITY COSTS

A. *Legal Standard and Burden of Proof—Allocation of Settlements*

1. General Rule: Insured Bears Burden of Proof

The general rule is that the policyholder bears the burden to apportion settlements that encompass a mix of claims/damages that are covered and not covered under the policy. For example, in *American Guaranty &*

Liability Insurance Co. v. U.S. Fire Insurance Co.,[25] the insured was a general contractor that was sued for damages involving faulty workmanship to a county courthouse. Some of the damages alleged against the insured were covered and others uncovered. The insured received settlement payments from subcontractors to resolve some of these claims and then turned to its insurers for the rest.

The insurers argued that the insured could "manufacture a covered loss through the internal bookkeeping maneuver of allocating the settlement money it received only to uncovered harms and then go after insurance coverage for the rest."[26] Concerned for a double recovery, the court held that the insured had the burden to show that the money that it received from subcontractors "did not fully compensate" the covered damages alleged against it.[27] Thus, the court required the insured to prove what portion of the settlement money it received was allocated to covered or non-covered damages.[28]

Similarly, in *Executive Risk Indemnity, Inc. v. Cigna Corp.*,[29] an insured settled a class action for breach of contract and RICO violations and submitted a claim to its excess professional liability carrier. In the ensuing coverage action, the insured argued that the insurer should prove which claims were excluded and outside of coverage, since the existence of some coverage was proven. The court, however, held that the insured had the burden to allocate because the insured was "the party that has access to the evidence and the parties' intent behind the settlement process."[30] In addition, the court noted that the settlement was based on business records that the insured had in its possession, the insured and insurer were equally sophisticated entities, and the insured's attorneys prepared the settlement agreement. Importantly, while the insured controlled its defense in this case, the court also noted that the result "may have been different if there were evidence of [the insurer's] breach of a duty to [the insured]."[31]

25. 255 F. Supp. 3d 677 (S.D. Tex. 2017).
26. *Id.* at 684.
27. *Id.* at 689.
28. *Id.; see also* Uvino v. Harleysville Worcester Ins. Co., No. 13 Civ. 4004 (NRB), 2015 WL 925940 (S.D.N.Y. Mar. 4, 2015), *aff'd*, No. 16-3225-cv(L), 16-3556-cv(XAP), 2017 WL 4127538 (2d Cir. Sept. 19, 2017) (insured having the burden to prove entitlement to coverage, as well as covered damages); Amerisure Ins. Co. v. Auchter Co., No. 3:16-cv-407-J-39JRK, 2017 WL 4862194, at *12 (M.D. Fla. Sept. 27, 2017) ("[Florida law] requires the party seeking recovery under a judgment or settlement agreement to allocate the judgment or settlement amount between covered and uncovered claims. The inability to allocate precludes recovery.").
29. 74 A.3d 179 (Pa. Sup. Ct. 2013), *appeal denied*, 89 A.3d 1285 (Pa. 2014).
30. *Exec. Risk*, 74 A.3d at 183.
31. *Id.* at 185 n.7.

2. D&O-Specific Tests: "Relative Exposure" and "Larger Settlement" Rules

Most D&O policies contain language expressly addressing the apportionment of covered and non-covered matters. For example, a typical clause provides:

> If both Loss covered under this policy and loss not covered under this policy are jointly incurred either because a Claim includes both covered and non-covered matters or covered and non-covered causes of action or because a Claim is made against both an Insured and any other parties not insured by this policy, then the Insured and the Insurer shall use their best efforts to fairly and reasonably allocate payment under this policy between covered Loss and non-covered loss based on the relative legal exposures of the parties with respect to covered and non-covered matters or covered and non-covered causes of action.

Courts generally apply one of two rules to address allocation under D&O policies containing the policy language referenced above. The "relative exposure" rule requires the parties to allocate costs between the insured officers and directors and those attributable to uninsured parties such as the company. This rule originated from *PepsiCo, Inc. v. Continental Casualty Co.*[32] In that case, PepsiCo settled claims involving a class-action suit naming it, its directors and officers, a former officer, and its accounting firm as defendants. PepsiCo sought complete indemnity under its D&O policy, which provided: "Loss shall mean any amount which the Directors and Officers are legally obligated to pay for . . . a claim or claims made against them for Wrongful Acts." The *PepsiCo* court held that this language required the parties to allocate the settlement costs between those attributable to the directors and officers (covered) and those attributable to PepsiCo and its accountants (uncovered). Thus, responsibility for the settlement was to be allocated based on the "relative exposures of the respective parties" to the action.[33]

In contrast, the "larger settlement" rule provides that, unless the uninsured corporation had some basis for liability independent of that of its directors and officers, the carrier must cover all of the defense and settlement costs for covered directors and officers, and their non-covered corporate entity. This rule originated from *Harbor Insurance Co. v. Continental Bank Corp.*[34] In that case, some Continental Bank investors filed securities fraud suits against Continental, and the first suit, a class-action, named as defendants Continental, twenty-five directors and officers, and other

32. 640 F. Supp. 656 (S.D.N.Y. 1986).
33. *PepsiCo*., 640 F. Supp. at 662.
34. 922 F.2d 357 (7th Cir. 1990).

employees. Continental settled the claims against it and sought indemnity from its insurers, which refused to pay. Although covered and non-covered parties were sued, the latter did not increase the liability of the former. Accordingly, the court held that the insurer must pay the entire loss. The court's opinion even went so far as to question why a covered loss should be allocated among covered and non-covered parties when the non-covered parties did not make things worse.

A 2020 decision by the Delaware Superior Court, addressed the effect of the increasingly common "best efforts to arrive at a fair and proper allocation"-type allocation term. In *Arch Insurance Co. v. Murdock*,[35] the term at issue, like most such terms, did not address what to do if the parties failed to agree. The court noted that this allocation provision was "mostly unhelpful" under the circumstances *(i.e.*, because the parties could not agree on allocation).[36] In the absence of language specifying what to do in the absence of the parties' agreement, the court ruled that the "larger settlement" rule applied.[37]

3. Exceptions

a. *Breach of Duty to Defend*

In *Harlor v. Amica Mutual Insurance Co.*,[38] the Supreme Court of Maine held that where the insurer had breached the duty to defend, the carrier did not lose the right to assert non-coverage as a defense to its duty to indemnify under Maine law. However, the court ruled that the insurer had the burden to prove it had no duty to indemnify an underlying settlement by apportioning the covered and uncovered claims. Importantly, the court concluded that "[i]f the insurer cannot meet this burden of proof, it may be held liable for the entire settlement."[39]

b. *Failure to Adequately Notify Insured of Need to Allocate*

Many jurisdictions recognize that, in mixed actions, the insurer must take the appropriate steps to preserve the right to allocate between covered and non-covered claims. For example, in *Remodeling Dimensions, Inc. v. Integrity Mutual Insurance Co.*,[40] homeowners served an arbitration demand on their home remodeling contractor for faulty workmanship and obtained a favorable general arbitration award. The insurer retained counsel to defend the contractor but refused to pay for the award. The contractor paid the award and commenced a declaratory judgment action against its insurer.

35. 2020 WL 1865752 (Del. Super. Ct. Jan. 17, 2020).
36. *Murdock*, 2020 WL 1865752 at *6.
37. *Id.* at *7.
38. 150 A.3d 793 (Me. 2016).
39. *Harlor*, 150 A.3d at 802.
40. 819 N.W.2d 602 (Minn. 2012).

The parties disputed whether the award included damages covered under the contractor's policy. The court held that, when insurer defends under a reservation of rights that includes covered and non-covered claims, the insurer must defend and also disclose to the insured its interest in obtaining a description of the claims proven and portions of the award attributable to each. Although conditioned on such an allocation being available, the insurer's failure to notify the insured caused prejudice to the insured because insurer failed to advise the insured of the insurer's interest in obtaining a written allocation of any award. The court noted that the insurer should notify the insured "at or near the time the defense of the claim is accepted under a reservation of rights."[41] Having failed to do so, the court concluded that the insurer must now prove that some part of the claim is uncovered.

B. *Insurer's Ability to Intervene in Underlying Action to Aid Allocation, or Otherwise Compel Use of Special Interrogatories*

One option potentially available to insurers is to intervene in the underlying action for the purpose of submitting jury interrogatories to aid in the allocation of covered and non-covered claims. Some courts are not receptive to these attempts by insurers. For example, in *J.T. Shannon Lumber Co. v. Gilco Lumber, Inc.*,[42] insurer moved to intervene in the underlying case to submit special jury interrogatories to allocate any damages awarded. The court denied the motion as untimely because it was ten months after reservation of rights was issued. In addition, the court also held that the insurer lacked a "direct interest" in the case because no verdict had been rendered against the insured, and there had been no finding that any of the claims asserted against the insured were uncovered.

The *J.T. Shannon* court squarely cautions that intervention should be sought as soon as an insurer knows that it has an interest in allocation. Moreover, diligence attempting intervention may be enough to put the burden on the party seeking coverage in a declaratory judgment action.

For example, in *Owners Insurance Co. v. Shep Jones Construction, Inc.*,[43] the underlying plaintiff obtained a general verdict against the insured contractor for damages involving faulty workmanship, among other things, and sought coverage from the contractor's insurer. The insurer sought, but was refused, intervention to underlying action to submit special jury interrogatories to allocate any damages awarded. Thereafter, the insurer sought a declaratory judgment that it had no duty to indemnify the verdict. The court held that party seeking coverage (here, the underlying plaintiff) has

41. *Remodeling Dimensions*, 819 N.W.2d at 618.
42. No. 2:07-CV-119, 2008 WL 4553048 (N.D. Miss. Oct. 7, 2008).
43. No. 08-AR-514-S, 2012 WL 1642169 (N.D. Ala. May 3, 2012).

burden to allocate, unless the insurer failed to make known the use and availability of a special verdict form. Since the insurer fulfilled this obligation by attempting intervention, the burden to allocate remained with the underlying plaintiff.

Some jurisdictions have strongly discouraged insurer intervention in the underlying action, to the point that insurers must think long and hard about even attempting to do so. It will not come a surprise to the practicing coverage lawyer that a leading example of this pro-inured approach comes from Washington State. In *Mutual of Enumclaw Insurance Co. v. Dan Paulson Construction, Inc.*,[44] the insured contractor had been sued for a variety of alleged construction defects. The underlying claims were mixed: some claims sought damage for covered property damage, but others likely fell within the "Your Work" and "Impaired Property" exclusions.

The underlying action was in arbitration rather than in court. The insured and underlying claimant, undoubtedly acting with an eye toward the ongoing allocation debate, agreed that the arbitrator would make any award on a lump-sum basis. This was contrary to "the arbitrator's usual practice of providing a detailed, itemized award," and the insurer "did not learn of the lump-sum award agreement until after the arbitration hearing had begun."[45]

Upon learning of the agreement, and after the insured refused the insurer's request to participate in the arbitration in order to seek allocation of any award, the insurer filed a declaratory judgment action. The insurer, MOE, then "issued a subpoena duces tecum to the arbitrator, scheduling the arbitrator's deposition upon written questions after the arbitration was concluded. In addition to making a comprehensive request for documents, the subpoena sought the arbitrator's thoughts regarding the arbitration. With the subpoena, MOE sent the arbitrator an ex parte cover letter explaining its coverage issues with [the insured]."[46] MOE later sent a second letter to the arbitrator, again explaining the dispute over the "Your Work" and related exclusions.

The insured demanded that MOE withdraw the subpoena, which the insurer later did. The insured and claimant later entered into a settlement agreement before the arbitrator rendered an award; the settlement agreement provide for a lump-sum payment and did not characterize or allocated the sum among the various alleged defects and property damage.

In the ensuing coverage litigation, the insured claimed that MOE's ex parte contact, via subpoena and two cover letters explaining the coverage

44. 169 P.3d 1 (Wash. 2007).
45. *Dan Paulson*, 169 P.3d at 5.
46. *Id.* at 5–6.

issues, constituted bad faith and gave rise to coverage by estoppel. The Washington Supreme Court held for the insured:

> MOE did risk a bad faith claim if it litigated coverage issues with DPCI [the insured] prior to the arbitration hearing. While defending under a reservation of rights, an insurer acts in bad faith if it pursues a declaratory judgment that it has no duty to defend and that action might prejudice its insured's tort defense. MOE sought to establish which claimed defects were excluded from coverage because they resulted from work performed by DPCI. Simultaneously, DPCI was contesting liability for *any* defects in the underlying arbitration action. To the extent that MOE prevailed, it would have directly prejudiced DPCI's position in the arbitration, clearly an act of bad faith.
>
> However, MOE was not facing the alternative to pay the entire settlement amount regardless of whether it was based on covered claims. An insurer defending under a reservation of rights is not automatically liable to pay the entire settlement amount—provided the insurer acts in good faith . . . . Absent a successful bad faith claim and the resulting coverage by estoppel, the insured still has the burden of proving how much of the [settlement] should be allocated to covered claims. Thus, MOE was not forced as a last resort to choose a third option: the subpoena and cover letters to the arbitrator. In fact, MOE was not faced with the prospect of paying the entire amount, regardless of coverage, until its own conduct—its choice to pursue that third option—raised the possibility of a bad faith claim by DPCI.
>
> [W]e hold that MOE did not successfully rebut the presumption of harm that arose from its bad faith conduct. MOE did not prove that its subpoena and *ex parte* communications with the arbitrator prior to and during the arbitration hearing did not harm or prejudice DPCI. To the contrary, the record supports that MOE's conduct caused significant uncertainty and increased risk for DPCI's defense. MOE's bad faith conduct interfered in DPCI's final hearing preparation, interjected insurance coverage issues into the arbitration, and created uncertainty concerning potential prejudicing of the arbitrator and the effect of MOE's interference on the confirmability of the arbitration award.[47]

The court noted that MOE had chosen not to seek to formally intervene in the arbitration, as permitted, at the discretion of the arbitrator, under the governing AAA rules. However, the rationale of the court's bad-faith holding would seem to have applied equally to a formal request to intervene. Accordingly, insurers must be extraordinarily wary of seeking to intervene in Washington actions, whether in court or arbitration. One can question the fairness of this outcome, given the efforts of the insured and underlying claimant to obscure the basis of any arbitration award and the resulting settlement.

47. *Id.* at 9–10, 11–12 (footnote omitted) (citations omitted) (internal quotations omitted).

C. *Policy Terms Addressing Apportionment of Covered and Non-Covered Claims*

As discussed above, insurers are increasingly including policy language that expressly provide for allocation of defense costs in mixed cases. While the extension of such terms to defense costs is relatively new, such terms have long been in use, mainly in D&O policies, with respect to indemnity coverage. The above-quoted policy provision is representative of the approach taken by most such provisions:

> Solely with respect to all Liability Coverage Parts:
>
> If **Loss** is incurred that is partially covered and partially not covered by this Policy, either because a **Claim** made against the **Insureds** includes both covered and uncovered matters or because a **Claim** is made against both covered and uncovered parties, such **Loss** shall be allocated as follows:
>
> (1) 100% of **Costs of Defense** shall be allocated to covered **Loss**; and
>
> (2) **Loss** other than **Costs of Defense** shall be allocated between covered and non covered **Loss** based upon the relative legal exposure of the parties to such matters.

The clause provides only limited guidance as to how settlement or judgment liability should be allocated "based upon the relative legal exposure of the parties to such matters." This wording leaves much room for case-specific advocacy concerning the facts and law governing the underlying claims.

D. *Practical Strategies for Coverage Counsel*

1. Recent Case Study: *UnitedHealth v. Executive Risk*

A recent decision from the Eighth Circuit presents a good roadmap of the various practical and strategy issues that counsel must consider when handling an allocation dispute, primarily involving the proof required. In *UnitedHealth Group, Inc. v. Executive Risk Specialty Insurance Co.*,[48] the court considered a settlement that UnitedHealth Group ("UHG") had entered into to resolve claims from two previous lawsuits under a single agreement.[49] One of the settled lawsuits involved antitrust claims that were potentially covered by UHG's liability insurance policy.[50] The other lawsuit asserted ERISA claims that were not covered.[51] When UHG sought to collect on its liability insurance policy, its insurers refused to pay, and UHG then sued them.[52]

48. 870 F.3d 856 (8th Cir. 2017).
49. *Id.* at 859.
50. *Id.*
51. *Id.*
52. *Id.* at 860.

The district court granted summary judgment in the insurers' favor and the Eighth Circuit affirmed, finding, *inter alia*, that UHG did not meet its burden to show how the settlement was allocated between the claims potentially covered by its insurance policy and those that were not.[53] The Eighth Circuit noted that an insured "need not prove allocation with precision, but it must present a non-speculative basis to allocate a settlement between covered and non-covered claims."[54] The burden to allocate the settlement between the covered claims and the non-covered claims must be met "with enough specificity to permit a reasoned judgment about liability."[55] Thus, as the appellate court concluded, UHG was not able to prove its claim under the insurance policy because it was not able to identify a non-speculative basis upon which to allocate which portion of the settlement applied to the potentially insurable antitrust claims.[56] The court explained that the "allocation inquiry examines how a reasonable party in [the plaintiff's] position would have valued the covered and non-covered claims . . . at the time of the settlement" and that in "complex lawsuits involving different legal claims and theories" a plaintiff must provide evidence about the relative strength and value of claims to properly allocate them.[57]

It is instructive to examine how the district court viewed the evidence needed to meet the burden.[58] The lower court noted that there were three kinds of evidence that a party could introduce to a fact finder to convince them that a settlement was properly allocated between indemnifiable and non-indemnifiable claims:

> (1) a party may introduce evidence of how the settling parties and their attorneys valued the claims at the time of settlement; (2) a party may introduce evidence of what was known to the parties and their attorneys at the time of settlement and ask the jury to assess the settlement value of each of the claims based on that information; or (3) a party may introduce expert testimony about the settlement value of the settled claims.[59]

The court then added that the appropriate evidentiary approach turns on the complexity of the case. For instance, a lay jury may be able to deduce the proper allocation of a settlement from merely looking at the record available to the parties at the time of settlement if the underlying facts are "uncomplicated," such as in a "simple slip-and-fall case."[60] However, in a

53. *Id.* at 863, 865–66.
54. *Id.* at 863.
55. *Id.*
56. *Id.* at 865–66.
57. *Id.* at 863–64.
58. *See* UnitedHealth Grp., Inc. v. Columbia Cas. Co., 47 F. Supp. 3d 863, 882–83 (D. Minn. 2014), *aff'd*, UnitedHealth Grp., Inc. v. Exec. Risk Specialty Ins. Co., 870 F.3d 856, 863 (8th Cir. 2017).
59. *Id.* at 881-82.
60. *Id.* at 882.

complex case like the one in UHG, "the jury would need the assistance of the expert testimony of an attorney who participated in litigating the underlying cases or an attorney who is hired to give expert testimony."[61] And if a party does not have an expert that can present testimony on this issue (which the plaintiff did not have in UHG), it cannot "fix this problem by handing the [evidence from the underlying record] to the jury and asking the jury to perform the [allocation] analysis that it failed to ask [its expert] to perform."[62] To do so would be to leave a "jury of farmers and mechanics and nurses and factory workers" to return a verdict "based on speculation."[63]

Then, in its affirmance, the Eighth Circuit elaborated further on the proof required: "To prove allocation, parties can present testimony from attorneys involved in the underlying lawsuits, evidence from those lawsuits, expert testimony evaluating the lawsuits, a review of the underlying transcripts, or other admissible evidence."[64] "Allocation require[s] either contemporaneous evidence of valuation or expert testimony on relative value to provide a reasonable foundation for a [fact-finder's] decision."[65] The court specifically noted that "[e]vents and circumstances happening after settlement are relevant only insofar as they inform how a reasonable party would have valued and allocated the claims at the time of settlement."[66]

2. Ensuing Battles on Motions *in Limine* and over Expert Testimony

Since the decision in *UnitedHealth*, several other decisions have been handed down that offer some guidance on how the courts are handling the allocation issue. Motions *in limine* and motions to exclude expert testimony are two areas where the issue is decided:

- In ruling on a motion *in limine* concerning expert testimony on allocation of liability among potential tortfeasors in settled lawsuits, the court in *Union Pacific Railroad Co. v. Colony National Insurance Co.*[67] held:

> If [insured's trial lawyer expert] offers testimony as to what the law requires, allows, or prohibits; or testimony about what a court likely would decide on a question of law; his opinions will be subject to objection, as exceeding the province of an expert witness. If, however, he offers testimony as to how reasonable lawyers with expertise in Oklahoma tort litigation would evaluate claims, defenses, evidence, trial strategy, and settlement, relevant to the facts of this case, then his

61. *Id.* at 883.
62. *Id.* at 881.
63. *Id.* at 883.
64. UnitedHealth Grp., Inc. v. Exec. Risk Specialty Ins. Co., 870 F.3d 856, 863 (8th Cir. 2017).
65. *Id.* at 865.
66. *Id.* at 864.
67. No. 8:13-CV-84, 2018 WL 1054315, at *3 (D. Neb. Feb. 23, 2018).

> opinions may assist the Court in its fact-finding mission. His lack of experience in railroad crossing litigation likely will affect the weight given to his opinions, but will not preclude him from being called by [insured] as an expert witness.

- In denying a motion *in limine* concerning expert testimony on how much of the settlement of the underlying action was to be allocated to covered claims, one court emphasized that "[i]n the allocation trial, this Court must look to evidence of what the parties in the Underlying Action knew at the time of the settlement."[68]
- In denying a motion to exclude expert testimony on allocation damages, the court *in In re RFC and RESCAP Liquidating Trust Action*[69] found:

> [Indemnitee's expert's] breach rate methodology does not warrant the exclusion of the Allocated Breaching Loss Approach. . . . First, [indemnitors] fail to show that the supposed flaws in [expert's] methodology are so significant that they practically negate the value of the Allocated Breaching Loss Approach to the fact finder. Second, the Court is persuaded that [expert's] decision to sample from the At-Issue Loans makes good sense given that the purpose of his study is to allocate the bankruptcy claims among [indemnitors], and those claims are premised on losses to loans sold by [indemnitee]. Thus, conceptually, those damages would necessarily have flowed from the loans that actually experienced economic losses, i.e. the At-Issue Loans. Third, these arguments go to weight of the evidence . . . .").

- One court denied summary judgment and allowed evidence on allocation to be presented to the jury.[70]

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68. Union Pac. R.R. Co. v. Colony Nat'l Ins. Co., No. 8:13-CV-84, 2018 WL 1247385, at *2 (D. Neb. Mar. 9, 2018) (Court rejecting insurer's argument that the court may not consider "information known to [expert] and shared with [insured] before the settlement, unless that information was known to the plaintiffs in the Underlying Action before the settlement").

69. No. 13-cv-3451, No. 13-cv-1716, 2018 WL 4489685, at *5 (D. Minn. Sept. 19, 2018).

70. *See In re* RFC & RESCAP Liquidating Trust Action, 332 F. Supp. 3d 1101, 1203–04 (D. Minn. 2018) (Indemnitor's summary judgment motion was denied and indemnitee permitted to present to jury the allocated breaching loss approach: such approach offers a reasonably certain basis for assessing and allocating damages that is not speculative, remote, or conjectural. "First, the Settlements at issue here involved related claims in a single action whereas United Health predominantly involved unrelated ERISA and antitrust claims from two separate cases from different jurisdictions. Second, the claims at issue here are premised on very similar or even identical Trust Agreement contracts and, as one would expect given that commonality, investors raised similar types of arguments against [indemnitee]. Third, [indemnitee] has offered competent expert testimony to assess the relative value of the settled claims. In particular, Donald Hawthorne, a seasoned RMBS litigator with experience settling RMBS cases, offers his opinion as to the weight a reasonable party would assign to the different categories of claims that were asserted in the bankruptcy based on his assessment of [indemnitee's] exposure to those claims and their likelihood of succeeding."); *In re* RFC & RESCAP Liquidating Trust Action, Case No. 13-CV-3451, 2020 WL 4728109, at *85

- Lastly, one court declined to declare any allocation so long as the underlying action has yet to be concluded.[71]

3. Preserving the Right to Allocation

Once a mixed-claim action is asserted against an insured, the reservation of rights sets the stage to allocate claims. The reservation, however, must be specific. It requires stating that the insurer will rely on a particular policy provision as a ground to later disclaim coverage

The Supreme Court of South Carolina analyzed these issues in *Harleysville Group Insurance v. Heritage Communities, Inc.*[72] In *Heritage Communities*, the insurer defended its insureds under a reservation of rights against claims of faulty workmanship, but a general verdict was obtained against the insureds. The insurer then commenced a declaratory judgment action to contest that the general verdict had any covered damages. Under South Carolina law, "costs to repair faulty workmanship itself are not covered under a CGL policy but costs to repair resulting damage to otherwise non-defective components are covered."[73]

The *Heritage Communities* court traced an insurer's duties on allocation back to its reservation of rights: "[a] reservation of rights letter must give fair notice to the insured that the insurer intends to assert defenses to coverage or to pursue a declaratory relief action at a later date."[74] The court reasoned that an insurer has a better vantage point because it usually controls the insured's defense. Thus, where an insurer defends under a reservation of rights, it must inform the insured of the need for a verdict allocating covered versus non-covered damages.

Based on *Heritage Communities*, an insurer's control of the defense is balanced with heightened duties owed to the insured. Requesting special interrogatories for the jury is part of the insurer's "duty not to prejudice the

(D. Minn. Aug. 14, 2020) (after thirteen-day bench trial, judgment entered for indemnitee; indemnitee presented multiple witnesses and experts in support of its proposed allocation, and its allocated breaching loss approach "provided a fair, practical, reasonable, and non-speculative way to allocate damages").

71. *See* Nat'l Union Fire Ins. Co. of Pittsburgh v. Viracon, Inc., No. 16-482, 2018 WL 3029054 (D. Minn. June 18, 2018) ("The Court cannot, however, determine on this record whether and to what extent the amount [insured] paid to settle the InterContinental lawsuit is excluded from coverage by the "your product" exclusion. There is no evidence before the Court on the terms of the settlement. [Insured] must establish what portion of the settlement is attributable to covered claims, and until that showing is made, no declaration regarding the settlement is appropriate. Similarly, because the 12W [underlying] litigation is ongoing, the Court cannot determine whether [insured's] liability in that litigation is covered by [insurer's] policies. . . . Any declaration regarding indemnity for the InterContinental settlement or the 12W litigation must await further record development.").

72. 803 S.E.2d 288 (S.C. 2017).

73. *Heritage Cmtys., Inc.*, 803 S.E.2d at 296.

74. *Id.* at 297 (quoting United Nat'l Ins. Co. v. Waterfront N.Y. Realty Corp., 948 F. Supp. 263, 268 (S.D.N.Y. 1966)).

insured's rights."[75] In the words of the court, "If the burden of apportioning damages between covered and non-covered were to rest on the insured, who is not in control of the defense, the insurer could obtain for itself an escape from responsibility merely by failing to request a special verdict or special interrogatories."[76]

The court noted that a critical error in the *Heritage Communities* reservation of rights was that it merely copied-and-pasted policy provisions. The insurer failed to state with particularity which provisions it would rely on to later defeat coverage. The court found that the insurer's "generic denials of coverage coupled with furnishing the insured with a verbatim recitation of all or most of the policy provisions (through a cut-and-paste method) is not sufficient."

Other courts have not taken such a strict view analysis of reservation of rights letters with respect to covered and uncovered claims and rather generally look to see if the insurer adequately informed the insured of the potential issue. In *Phase II Transportation, Inc. v. Carolina Casualty Insurance Co.*,[77] the insurer sought reimbursement for part of a settlement that it paid under a reservation of rights for one of two underlying actions. One action alleged covered claims, but the other contained non-covered claims. The court specifically noted that the reservation of rights "adequately and timely" preserved the right to reimbursement.[78] Thus, although settlement discussions involved covered claims with respect to the underlying action failing to assert a covered claim, the court recognized that no covered claims were pled. Therefore, the insured could not show that the disputed portion of the settlement included covered claims; the burden did not shift to the insurer, and the insured was ordered to reimburse the insurer.

4. Role of Declaratory Judgment Actions

When there are disputes between apportionment of covered and uncovered claims, parties may contemplate filing a declaratory judgment action to get a declaration as to each party's payment obligations. The timing of a declaratory judgment action, and other procedural requirements, vary from jurisdiction to jurisdiction. For example, some courts will stay consideration of an insurer's potential duty to indemnify until resolution of the underlying matter. Other jurisdictions require all "interested" parties to be named, which may include the underlying claimants. Regardless of the procedural nuances, for insurers considering a motion to intervene in the underlying action to assist in the apportionment question, having a

75. *Id.* at 299 (quoting Magnum Foods, Inc. v. Cont'l Cas. Co. 36 F.3d 1491, 1498 (10th Cir. 1994)).
76. *Id.*
77. 228 F. Supp. 3d 999 (C.D. Cal. 2017).
78. *Id.* at 1007.

pending declaratory judgment action may help bolster a request for intervention by showing to the court that it is necessary to help resolve the pending coverage action.

Parties may be wary of filing declaratory judgment actions, fearing that the length of time that it would take to resolve, as compared to the speed of the underlying case, would make such declaratory judgment actions impractical. However, practitioners should note that, under Rule 57 of the Federal Rules of Civil Procedure, "[a] court may order a speedy hearing of a declaratory judgment action." Many state court rules of civil procedure are in accord with the federal rule. This rule provides a basis for counsel to argue, if necessary, that the declaratory judgment action must proceed expeditiously, considering its potential impact on the underlying litigation.

IV. CONCLUSION

In an underlying case involving both covered and uncovered claims, the liability insurer's initial coverage determination is only a starting point. The question of whether and how costs may be allocated between covered and uncovered claims can have a dramatic practical effect on the insurer's obligation to pay. Allocation debates demand careful consideration of emerging policy terms, widely varying state law, and the underlying allegations and defense tasks, and therefore provide an opportunity for coverage counsel on both sides of the aisle to add value for their respective clients.