

## Litigating Liability Insurance Coverage

By: Steven E. Leder

Unresolved coverage issues, new causes of action and changes in the standard policy forms have driven an increase in insurance coverage litigation. Whether you are representing an insurer or a policyholder in a coverage dispute, your decisions as to whether to sue, what to allege, when to sue, whom to sue, and where to sue may determine who wins and who loses.

### **What causes of action to allege**

There are overlapping causes of actions available to the different parties. Policyholders and insurers may each seek the court's guidance in construing the policy by filing a declaratory judgment action. A court's declaratory judgment enables the insurer and the insured (or putative insured) to understand their rights and duties so that they can make responsible decisions. Congressman Gilbert remarked in debate concerning the federal declaratory judgment statute:

Under the present [pre-Declaratory Judgment Act] law, you take a step in the dark and then turn on the light to see if you stepped into a hole. Under the declaratory judgment law you turn on the light and then take the step.

*Step-Saver Data Sys., Inc. v. Wyse Tech.*, 912 F.2d 643, 649-650 (3d Cir. 1990)(citing 69 Cong. Rec. 2108 (1928)).

The policyholder may also allege breach of contract if the insurer has denied a duty to defend or indemnify. An insurer may sue to rescind the policy for misrepresentations in the application. Further, where there is a judgment against the insured in excess of the policy limits, an insured may allege "bad faith" or "wrongful failure to settle within policy limits". However, when can they file suit?

## When to sue

Should you file a declaratory judgment before the underlying tort case is tried, after it is tried, or should you move to intervene? In Maryland, a pre-tort trial declaratory judgment action is generally not permitted where the facts to be determined in the coverage action are intertwined with the facts to be determined in the underlying tort trial. *Allstate Ins. Co. v. Atwood*, 319 Md. 247, 572 A.2d 154, (1990); *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 347 A.2d 842 (1975); *Benning v. Allstate Ins. Co.*, 90 Md. App. 592, 602 A.2d 233 (1992). A pre-tort trial declaratory judgment action is permitted where the coverage issue arises out of a separate and independent question which will not be determined in the underlying tort trial. *Id.* Intervention by the insurer is barred in Maryland state court. *Allstate Ins. Co. v. Atwood*, 319 Md. 247, 572 A.2d 154 (1990). This creates some problems with allocating damages where there is a general verdict, which are discussed below. Most declaratory judgment actions in the Maryland state courts will be filed after the tort trial.

The Declaratory Judgment Act, 28 U.S.C. § 2201(a) provides a federal declaratory remedy. The exercise of jurisdiction under the Act is not compulsory. There is a four part test for entertaining an insurance coverage action during the pendency of the tort trial in federal court; *i.e.*:

- (i) the strength of the state's interest in having the issues raised in the federal declaratory action decided in the state courts;
- (ii) whether the issues raised in the federal action can more efficiently be resolved in the state court in which the action is pending;
- (iii) whether permitting the federal action to go forward would result in unnecessary "entanglement" between the federal and state court systems, because of the presence of "overlapping issues of fact or law";

(iv) whether the declaratory judgment action is being used merely as a device for “procedural fencing” – that is, to control the choice of forum in a race for res judicata or to obtain a federal hearing in a case otherwise not removable.

### **Statute of Limitations**

The three-year statute of limitations looms large in deciding when to sue. MD. CODE ANN., CTS. & JUD. PROC. § 5-101. The statute of limitations runs from the time of the breach of contract. Maryland is among the majority of courts which hold that the statute of limitations on a claim for breach of the duty to defend runs from the date of final judgment in a tort suit rather than the denial of coverage. *See Vigilant Ins. Co. v. Luppino*, 352 Md. 481, 723 A.2d 14 (1999); *Commercial Union Ins. Co. v. Porter Hayden Co.*, 116 Md. App. 605, 698 A.2d 1167 (1997). The breach of duty to indemnify also runs from the date of judgment. *Commercial Union, supra*; *Luppino v. Vigilant Ins. Co.*, 110 Md. App. 372, 677 A.2d 617 (1996).

### **Whom Should You Sue?**

The insured and the insurer should make certain that all parties that must be bound by the judgment are included as parties. If the tort plaintiff is not joined as a party, he may not be bound by the judgment. *Zelinski v. Townsend*, 163 Md. App. 211, 878 A.2d 623 (2005), *rev'd on other grounds*, 393 Md. 83, 899 A.2d 835 (2006). Some plaintiffs do not wish to participate and may be dismissed if they agree to be bound by the outcome of the declaratory judgment action.

### **Where to Sue**

The first step in deciding where to sue is to be certain that there is jurisdiction over all the parties who must be bound by the judgment. You may decide to sue in the United States District Court for the District of Maryland, another federal court, Maryland

state court, or another state's court. Insurers, most of whom are not Maryland residents, may prefer to litigate in federal court. Since each forum applies its own choice of law rules, the selection of the forum may also determine which state's law applies.

### **Choice of Law**

Maryland applies the substantive law of the place where the contract was made (“*lex locus contractus*”) to issues of contract interpretation. *See Cooper v. Berkshire Life Ins. Co.*, 148 Md. App. 41, 55, 810 A.2d 1045, 1052-1053 (2002); *Commercial Union, supra*. *Cf. Am. Motorists Ins. Co. v. ARTRA Group, Inc.*, 338 Md. 560, 659 A.2d 1295 (1995)(*renvoi*). Contracts are made in the place where the last act occurs necessary to give the contract a binding effect. *Commercial Union, supra*, 116 Md. App. at 672, 698 A.2d at 1200. Typically, the place where the policy is delivered and the premiums are paid or where the policy is countersigned is the place of the contract. *Md. Cas. Co. v. Armco, Inc.*, 643 F. Supp. 430 (D. Md. 1986), *aff'd*, 822 F.2d 1348 (4th Cir. 1987); *E. Stainless Corp. v. Am. Prot. Ins. Co.*, 829 F. Supp. 797 (D. Md. 1993). Issues concerning the performance of the insurance contract are governed by the law of the place of performance. *First Nat. Bank & Trust Co. of W. Md. v. Security Mut. Cas. Co.*, 285 F. Supp. 337 (D. Md. 1968).

The doctrine of *renvoi* is an exception to this rule. Under this doctrine, if Maryland's choice of law rule results in the application of another state's law and that other state's choice of law rule (applying the law of the state with the “most significant contacts” for example) dictates the application of Maryland substantive law, *renvoi* permits the Maryland court to apply Maryland law to the dispute. *Am. Motorists Ins. Co. v. ARTRA Group, Inc.*, 338 Md. 560, 659 A.2d 1295 (1995).

A federal court sitting in diversity will normally apply the substantive choice of law principles of the state in which it is located. *Klaxon Co. v. Stentor Elec. Mfg. Co.*, 313 U.S. 487, 496, 61 S. Ct. 1020, 1021 (1941).

### **Discovery in General**

Discovery in coverage litigation is much different from discovery in tort litigation. The scope of discovery depends upon the issue. In duty to defend cases, generally, no significant discovery is needed by the insurer, since the duty to defend is based upon the allegations of the Complaint. *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 347 A.2d 842 (1975). However, since insureds may rely upon extrinsic evidence to bring an action within coverage, discovery may prove helpful to the insured. In duty to indemnify cases, the evidence is generally limited to that produced at the underlying tort trial. In “bad faith” duty to settle within policy limits cases, more extensive discovery is permitted.

Whether information as to other claims and lawsuits is discoverable is an issue for the trial court. Most courts find it marginally relevant at best and either not discoverable or subject to limited discovery. *North River Ins. Co. v. Mayor and City Council of Baltimore*, 343 Md. 34, 67, 680 A.2d 480, 497 (1996)(“[t]he numerical majority of the cases deny any discovery of the records of other insureds, either on the ground that it will not lead to the discovery of relevant evidence, or on the ground that the relevance is so clearly outweighed by the burden of production that production is denied”).

### **Depositions**

As with discovery in general, the purpose and goals of the deposition vary depending upon whether the suit concerns the duty to defend, the duty to indemnify or

“bad faith.” In a duty to defend case, policy language and the allegations of the complaint drive the court’s determination of coverage. Hence, it is rarely useful to depose the adjuster in a duty to defend case. The handling of the file and the insurer’s reasons for denying coverage or reserving rights are not relevant to the determination of coverage by the court. The same goes for a duty to indemnify case, where the jury verdict sheet or the evidence adduced at trial – not the reasons the insurer accepted or denied coverage – determines coverage. Insureds, however, tend to notice the deposition of the claims adjuster as a knee jerk reaction. Of course, in a bad faith case, the issues concerning handling of the file and settlement negotiations make the deposition of the adjuster central.

The deposition of the insured is useful in a duty to defend case to flesh out any extrinsic evidence the insured relies upon and the related factual basis of the underlying plaintiffs’ allegations, such as whether the insured intended or expected the plaintiff’s injury or whether the putative insured had permission to drive the insured motor vehicle. Further, it is an opportunity to pin down the insured’s claim that extrinsic evidence brings the case within coverage.

Experts generally should not be permitted to testify since the policy is interpreted based upon its plain language as understood by laypersons. *Truck Ins. Exch. v. Marks Rentals, Inc.*, 288 Md. 428, 433-434, 418 A.2d 1187, 1190 (1980)(citing *Della Ratta, Inc. v. Am. Better Community Developers*, 38 Md. App. 119, 131, 380 A.2d 627, 635 (1977)). Expert testimony may be introduced to assist in interpreting particularly specialized and/or arcane policies. *Johnson & Higgins of Pa., Inc. v. Hale Shipping Corp.*, 121 Md. App.

426, 710 A.2d 318 (1998). Nonetheless, experts are frequently named in coverage litigation.

### **Burden of Proof**

Once you have assembled your evidence, you have to prove your case. The insured has the burden of proving every fact essential to his or her right to recover. *See N. Am. Acc. Ins. Co. v. Plummer*, 167 Md. 670, 176 A. 466 (1935); *Towne Mgt. Corp. v. Hartford Acc. & Ind. Co.*, 627 F. Supp. 170 (D. Md. 1985); *Royal Ind. Co. v. Wingate*, 353 F. Supp. 1002 (D. Md. 1973). The insurer has the burden of proving any exclusion under the policy. *Finci v. Am. Cas. Co.*, 323 Md. 358, 394, 593 A.2d 1069, 1087 (1991). *See also Warfield-Dorsey Co. v. Travelers Cas. & Sur. Co. of Illinois*, 66 F. Supp. 2d 681, 689 (D. Md. 1999). The insurer has the burden of proving prejudice from the insured's violation of a notice provision. *Prince George's County v. Local Gov't Ins. Trust*, 388 Md. 162, 187-88, 879 A.2d 81, 97 (2005). The insurer has the burden of proving that the insured made a misrepresentation in the application for the policy. *Cohen v. Am. Home Assur. Co.*, 255 Md. 334, 342, 258 A.2d 225, 229 (1969). Lost policies require the proponent to establish the fact of loss and terms and conditions of the policy by clear and positive evidence. *See Barranco v. Kostens*, 189 Md. 94, 54 A.2d 326 (1947). The insured has the burden of making the allocation where part of the loss is within the policy and part is not.

### **Allocation**

#### **a. Allocating a verdict between insurer and insured**

Who has the burden of apportioning the loss between covered and uncovered damages when there is a general verdict? Allocation is simple where the verdict is

distinguished between covered and uncovered claims. If there is no specific allocation, the court must determine what portion is allocated to covered claims. *St. Paul Fire & Marine Ins. Co. v. Englemann*, 639 N.W.2d 192 (S.D. 2002); *Comsys Info. Tech. Services, Inc. v. Twin City Fire Ins. Co.*, 130 S.W.3d 181 (Tex. App. 2003); *Bohrer v. Church Mut. Ins. Co.*, 965 P. 2d 1258 (Colo. 1998); *Agency of Nat. Res. v. U.S. Fire Ins. Co.*, 796 A.2d 476 (Vt. 2001). Generally, the insured has the burden of proving a loss is within coverage. Where the verdict is mixed, it remains the insured's obligation. *Universal Underwriters Ins. Corp. v. Reynolds*, 129 So.2d 689, 692 (Fla. App. 1961). A few courts have shifted the burden to the insurer in some situations, such as where the insurer controlled the defense and failed to request special jury interrogatories to allocate the verdict. *Duke v. Hoch*, 468 F.2d 973 (5th Cir. 1972). *See also Magnum Foods, Inc. v. Cont'l Cas. Co.*, 36 F.3d 1491, 1498-1499 (10th Cir. 1994); *Gay & Taylor, Inc. v. St. Paul Fire & Marine Ins. Co.*, 550 F. Supp 710, 716-717 (W.D. Okla. 1981); *Palermo v. Fireman's Fund Ins. Co.*, 676 N.E.2d 1158 (Mass. App. 1997); *Buckley v. Orem*, 730 P.2d 1037, 1043 (Idaho App. 1986); *Liquor Liability Joint Underwriting Ass'n v. Hermitage Ins. Co.*, 644 N.E.2d 964 (Mass. 1995). *Cf. Int'l Commc'n Material, Inc. v. Employer's Ins. of Wausau*, 1996 WL 1044552 at \*9-10 (W.D. Pa. 1996)(distinguishing that case from *Duke, supra*, on the basis of who controlled the defense).

Some Federal Courts have permitted insurers to intervene pursuant to FRCP Rule 24 to request special jury interrogatories or a verdict form. *See e.g., Thomas v. Henderson*, 297 F. Supp 2d 1311 (S.D. Ala. 2003).

**b. Allocating a verdict among insurers with concurrent coverage**

In cases with concurrent (overlapping) insurance policies, Maryland courts look to the policies' "other insurance" clauses to determine allocation. There are three common types: escape clauses are designed to prevent a policy from responding at all if there is other available insurance, excess clauses purport to make a policy excess to other available insurance, and pro rata clauses attempt to allocate the indemnity obligation among primary insurers based on the ratio of their policy limits to the total available coverage. *See Consol. Mut. Ins. Co. v. Bankers Ins. Co. of Pa.*, 244 Md. 392, 395-96, 223 A.2d 594, 596 (1966).

After determining which types of clauses are at issue, the court will then attempt to reconcile the clauses, if possible. "This approach recognizes that the rights and liabilities of the different insurers involved should depend, as far as possible, upon the specific language of the policies." *Id.* at 396, 223 A.2d at 597. An excess clause prevails over a pro rata clause in Maryland. As a result, the policy with a pro rata clause will be primary, and must cover the loss up to its policy limits before the policy with the excess clause will respond. *Id.* at 399, 223 A.2d at 598. When the Court of Appeals is reconciling an escape and excess clause, the result depends upon the specific wording of the "other insurance" provisions. An escape clause will prevail over an excess clause if the escape clause specifically states that it will be activated by the existence of excess coverage. *State Farm Mut. Auto Ins. Co. v. Universal Underwriters Ins. Co.*, 270 Md. 591, 312 A.2d 265 (1973). On the other hand, an excess clause will prevail over a broadly worded escape clause; in that case the policy with the excess clause will serve as excess insurance and the policy with the escape clause will be primary. *Zurich Ins. Co. v. Cont'l Cas. Co.*, 239 Md. 421, 212 A.2d 96 (1965). When a Maryland court cannot

reconcile competing clauses, it will equitably distribute the insurers' liability for the verdict. *Ryder Truck Rental, Inc. v. Schapiro & Whitehouse, Inc.*, 259 Md. 354, 366, 269 A.2d 826, 832 (1970)(excess clauses); *Celina Mut. Cas. Co. of Ohio v. Citizens Cas. Co. of N.Y.*, 194 Md. 236, 245, 71 A.2d 20, 24 (1950)(pro rata clauses); *Centennial Ins. Co. v. State Farm Mut. Auto. Ins. Co.*, 71 Md. App. 152, 524 A.2d 110 (1987)(escape clauses).

### **c. Allocating a verdict among insurers with consecutive coverage**

In cases with consecutive insurance policies covering the same risk, there are three methods of allocating the duty to indemnify the insured: (1) "joint and several" or "all sums", (2) "actual injury," and (3) "pro rata" by time on the risk or by policy limits. The Maryland Court of Special Appeals has adopted the third method, pro rata by time on the risk. *Mayor and City Council of Baltimore v. Utica Mut. Ins. Co.*, 145 Md. App. 256, 309, 802 A.2d 1070, 1101 (2002). Under this method, each insurer's indemnity burden is proportionate to the length of time its policy covered the risk. *Id.* Uninsured periods are allocated to the insured, unless they are caused by the unavailability of insurance during that time. *Id.* at 313, 802 A.2d at 1104. *See also Scottsdale Ins. Co. v. Am. Empire Surplus Lines Ins. Co.*, 811 F. Supp. 210 (D. Md. 1993)(predicting that Maryland would use the pro-rata method of allocation).

### **Attorney's Fees**

Attorney's fees are recoverable by the insured in a duty to defend action, but not in a duty to indemnify action. Maryland follows the American Rule, which provides that each party bears his own attorney's fees in breach of contract actions. *Bausch & Lomb Inc. v. Utica Mut. Ins. Co.*, 355 Md. 566, 590, 735 A.2d 1081, 1094 (1999). There is, however, an exception to this rule in actions involving third-party insurance policies.

Where a policyholder prevails in a declaratory judgment action after its insurer has denied a duty to defend, attorney's fees may be recovered. *Id.*; *Mesmer v. MAIF*, 353 Md. 241, 264, 725 A.2d 1053, 1064 (1999); *Collier v. MD-Individual Practice*, 327 Md. 1, 11-17, 607 A.2d 537, 542-545 (1992). The underpinnings of this rule are explained in *Bankers and Shippers Ins. Co. of N.Y. v. Electro Enterprises, Inc.*, 287 Md. 641, 648-649, 415 A.2d 278, 282-283 (1980)(citing *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 409-10, 347 A.2d 842, 851 (1975)).

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