

Insurer Cannot Allocate Defense Costs When It Fails to Defend Insured

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A federal district court, applying Massachusetts law, has ruled in favor of an insured, holding that 1) allegations in the operative complaint regarding the insured's misconduct "immediately following" his employment were potentially covered and therefore triggered the insurer's duty to defend, 2) the insurer could not allocate defense costs between covered and non-covered claims because it failed to defend the insured initially and 3) the insurer had a duty to indemnify the insured for damages attributable to a covered claim despite the fact that the jury did not distinguish between covered and non-covered conduct. *Dash v. Chicago Ins. Co.*, 2004 WL 1932760 (D. Mass. Aug. 23, 2004).

The insurer issued a legal malpractice insurance policy that provided coverage for "Damages for Claims...made against the Insured...arising out of any negligent act, error, omission or Personal Injury in the rendering of or failure to render Professional Services by the Named Insured." In addition, the policy stated that the insurer "shall have the right and duty to defend any suit against the Insured seeking Damages to which this insurance applies even if any of the allegations of the suit are groundless." The policy also contained two exclusions barring coverage for 1) "claims made '[b]ased on or arising out of the rendering of or failure to render Professional Services by any insured by an insured as an employee...or officer of...[a] corporation or other business enterprise'" and 2) "claims '[b]ased on any negligent act, error, omission or Personal Injury in the rendering of or failure to render Professional Services by the Insured for his employer.'"

The insured plaintiff was a large shareholder and an officer of two separate companies whose stock was acquired by a third company. After the purchase, the insured became general counsel and a vice president of the acquiring entity. The three companies later merged to form a new entity for which the insured then served as general counsel. The new company subsequently filed suit against the insured and the other directors and officers alleging multiple claims, including breach of fiduciary duty and breach of the covenant of good faith and fair dealing. The complaint also alleged that the insured breached his duty of loyalty and had committed legal malpractice "[d]uring and immediately following the period he served as [] General Counsel." The insurer denied coverage based on the two exclusions regarding the insured's conduct as an employee and the rendering of professional services for his employer.

The court first addressed whether the insurer had a duty to defend the insured. The court noted that the complaint contained an allegation stating that the insured breached his duty of loyalty "[d]uring and immediately following the period he served as [] General Counsel." The insurer admitted that this allegation brought the complaint within the "general coverage language in the Policy," but contended that the two exclusions applied to bar coverage. The court determined that the exclusions did not apply because the insured could have committed legal malpractice without being an employee or without rendering a professional service to his employer. In so ruling, the court stated that the exclusions contained the phrase "based on," which can be interpreted to mean that the misconduct must occur "while an employee." The court also observed that an attorney has an ongoing duty to his client even after his employment has been terminated. Because the complaint alleged that the insured's misconduct occurred immediately following his employment, the court held that the complaint alleged a claim that was potentially covered by the policy, and thus triggered the policy's duty to defend.

The court next addressed whether the insurer could allocate defense costs between covered and non-covered claims. The court first noted that an insurer must defend an entire suit where any claim is potentially covered. It then indicated that, although it was "sympathetic" to the insurer regarding the payment of defense costs for non-covered claims, the insurer "is not seeking reimbursement for costs it incurred in defending [the insured] against non-covered claims; rather, [the insurer] wholly defaulted on its duty to defend and seeks retroactively to apportion out the costs for non-covered claims." The court therefore held that the insurer was "not entitled to apportion defense costs as between claims covered and not covered under the Policy."

Finally, the court held that the insurer had a duty to indemnify the insured for the damages related to the legal malpractice claim despite the fact that the "jury's special verdict did not adequately distinguish between covered and non-covered conduct." The court first noted that the insurer did not establish that extrinsic evidence could be used to determine whether the damages were attributed to a non-covered claim. The court observed that "[t]he special questions posed to the jury did not indicate the basis for the legal malpractice judgment, and [the insurer] cannot now retroactively partition the verdict with extrinsic evidence." The court further indicated that, had the insurer "satisfied its duty to defend [], it could have adequately protected against a judgment that did not sufficiently distinguish between covered and non-covered conduct" through the use of a special verdict form. Noting its previous determination that "a lawyer owes a former employer ongoing ethical obligations which could result in malpractice liability based on conduct unrelated to any rendering or failure to render legal advice as an employee," the court held that the insurer must indemnify the insured for the entire malpractice judgment because the insurer "failed to prove that any [] allocation is appropriate."

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