The Distinction Between the Duty to Pay Defense Costs and the Duty to Indemnify Defense Costs

Article By

Larry P. Schiffer

Squire Patton Boggs (US) LLP
Insurance and Reinsurance Disputes Blog

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Common forms of commercial general liability policies typically include provisions requiring the insurer to defend the insured regardless of whether the claim is valid or not, as long as the claim is within the coverage grant of the insurance policy. The typical language provides that the insurance company has the right and duty to defend the insured against any suit seeking damages for bodily injury or property damage to which the insurance applies. Other policies, however, including excess policies, may not include a duty to defend and may only provide for indemnification of defense costs actually paid for a covered claim. In a recent Summary Order, the Second Circuit reviewed this distinction in a coverage dispute involving marine primary and excess polices covering an oil transport and storage facility in Panama.

In Petroterminal De Panama, S.A. v. Houston Cas. Co., No. 15-2941-cv, (2d. Cir. Sept. 8, 2016) (Summary Order), two policies covered the insured for its oil transport and
storage facilities. The neither policy contained an express provision providing for a duty to defend, but each had language indicating that the policies would pay on behalf of the insured any sums it may be liable to pay, including costs arising from the claim (the excess policy had different language, but the effect was the same). A claim arose after a pipeline control valve failed. The insured and other companies connected to the facility were sued and the Panamanian court issued an attachment against one of the other companies, which was eventually withdrawn and found to be violative of due process. The company that suffered the attachment sued the insured claiming damages and breach of its agreement with the insured. The insurers agreed to advance 50% of the defense costs subject to reimbursement by the losing party in any subsequent coverage action. Ultimately, the court found that the attachment caused the damages (deemed a force majeure) and the insured was not liable under its contract with the other company.

In the subsequent coverage action, the insured sought full payment of its defense costs from the insurers. The district court granted summary judgment to the insurers after finding that the claims brought against the insured were not covered under the policies because the illegal attachment caused the damages rather than a covered occurrence (and also that the claims were excluded under the terms of the policies).

The Second Circuit affirmed on appeal. As a threshold issue, the court had to decide whether the policies imposed a duty to defend along with a duty to pay defense costs for claims arguably covered or simply a duty to indemnify. The circuit court noted that when construing a policy to determine whether the insurer has a duty to defend or just a duty to indemnify, the courts will find a duty to defend only where it is expressly stated. The insured recognized that the policies did not impose a duty to defend, but argued that the policies required the payment of defense costs as they were incurred. The insured also argued that this duty to pay turned solely on whether the complaint alleged facts that brought the action within the scope of coverage under the policies (similar to a duty to defend analysis).

The court rejected the policyholder’s arguments. It found that the excess policy (a “bumbershoot” policy) only imposed a duty to indemnify. The court held that the excess insurers were only liable for the insured’s defense costs if the judgment established that the underlying claims were covered by the policy. Because that was not the case (and because the claim fell within the exclusion for damages resulting from capture, seizure, arrest, etc.), there was no obligation to pay defense costs. A similar analysis was applied to the primary policy.

The distinction between a duty to defend policy and a duty to indemnify policy is meaningful when there are significant defense costs incurred. Many policyholders see commercial general liability policies as litigation insurance for defense costs as well as insurance for their actual liabilities. When the policy is a duty to defend policy, the insurer’s payment of defense costs prior to any definitive judgment on whether there is coverage is generally non-recoverable (unless there is an express recoupment clause). When the policy is not a duty to defend policy, there may be no “litigation insurance,” and the carrier may be able to recoup any defense costs advanced.

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