

# Opening the Umbrella:

## How we undid the wrongful denial of a \$1 million auto claim

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On February 26, 2001 a teen driver named Kevin McDermott was driving his father's car when he rear-ended a vehicle driven by a second Delaware driver, Martha Smith<sup>1</sup>. The impact was so violent that it caused Ms. Smith's vehicle to hurtle forward, from a standing position, over 300 feet. Ms. Smith suffered multiple fractures of her cervical and thoracic vertebrae, which splintered into her spinal cord like shrapnel. She will live her remaining years in a state like quadriplegia. Indeed, the neurological surgeon who treated her injuries testified at deposition that Ms. Smith "was very nearly, completely quadriplegic when she...first arrived"; and her medical records show her diagnosis as "incomplete quadriplegia."

In other words, Ms. Smith suffered a catastrophic injury. She was virtually unable to move her extremities (beyond what her surgeon referred to as "a little flicker of a toe") for weeks after the collision. Her progress throughout the remainder of 2001 was almost imperceptible. She spent much of that year in a wheelchair, and has been forced to rely on wheelchairs and other assistive devices since. Her treating physicians confirm that the injury to her cervical spine is permanent, and will leave her with frequent, periodic episodes of "unrelenting, severe, debilitating" pain.

Ms. Smith thus faces a future of total and permanent disability, profound physical impairment and lifelong pain. Her remaining years will be punctuated by visits to doctors' offices, physical therapy appointments and a dizzying array of pain medications, muscle relaxants and anti-inflammatory drugs. She will suffer recurrent falls, chronic bladder problems, spasticity, and an increased propensity for urinary tract infections. Her "boardable" medical expenses (past and future) approach \$2.5 million. Her lost earnings (again past and future) exceed \$500,000. Her claim for pain and suffering, meanwhile, must reasonably be valued in the many millions of dollars.

And so we come to the question of insurance. The McDermott policy was covered for auto liability, and the policy provided a combined single limit of liability of \$500,000. Not long after Ms. Smith commenced her personal injury action against the McDermotts, the insurer tendered the full \$500,000 to her attorney.

But Kevin McDermott's father was a small business owner, and he had purchased a commercial umbrella liability policy from a second insurer, ABC Mutual Insurance Company<sup>2</sup>. The ABC policy expressly included "auto hazard" coverage for vehicles

owned by the elder McDermott. It had per-occurrence limits of \$1 million, payable on exhaustion of \$500,000 in underlying limits. Since the \$500,000 underlying limit had been paid (and in light of the catastrophic nature of the loss), one would have expected ABC to promptly tender its \$1 million policy limit as well.

But that didn't happen. Instead, ABC denied coverage altogether, and stuck by its denial for two full years. Yet even its denial was not easily secured. In fact, ABC had been

placed on notice of the claim by at least August 2002, but its only response was to invite Ms. Smith's attorney, a respected DTLA member, to offer *his* analysis of the coverage issue. Thus, for the first two years after receiving notice, ABC neither paid the claim nor explained its position. Faced with a claim of this size and importance, it was apparently satisfied to force the claimant's attorney to "petition" for coverage, without affirmatively providing its own coverage decision to either the policyholder or Ms. Smith.

And so ABC communicated no determination of coverage to the McDermotts at any time during 2002 and 2003. On August 5, 2004 (the second anniversary of ABC's receipt of notice) an adjuster named Joe Jones, from ABC's Nashville, Tennessee office, finally wrote to the elder McDermott, denying coverage for the February 26, 2001 collision.

The adjuster explained ABC's denial in a single paragraph:

There are several reasons we find no coverage for this loss under your Commercial Umbrella Policy. Kevin McDermott does not meet the definition of an "insured" as outlined above. It does not appear that the conditions of your policy have been met as we have never received a copy of the lawsuit filed in this matter. Finally, the vehicle involved in the accident is not covered for liability on any of the policies listed in the Schedule of Underlying Insurance. Since the loss is not covered under any of the scheduled underlying policies (sic), it is not covered under the Commercial Umbrella Policy.

ABC thus denied coverage for three (and only three reasons): First, ABC said that young Mr. McDermott did not qualify as an "insured" within the meaning of the policy. Second, ABC said that it never received a copy of the Smith v. McDermott complaint. Third, ABC said that because the car driven by Mr. McDermott was not covered under any policy listed in its "Schedule of Underlying Insurance", it could not be covered under the ABC policy.

1 All personal and company names in this article are fictitious names except those referred to in existing case law.

2 Also a fictitious name.



## Opening the Umbrella

This was the posture of the coverage dispute when attorneys for Ms. Smith and the McDermott family came to me. After reviewing the ABC policy, the underlying pleadings and deposition transcripts, and proof of the underlying insurer's tender of the \$500,000 underlying limit, I agreed to represent the McDermotts in a coverage action against ABC. The outcome of that dispute offers valuable lessons in dealing with recalcitrant insurers generally, and ABC in particular.

### The Waiver Issue

A strong argument can be made that ABC waived all coverage defenses by waiting two years to disclaim coverage. It is well established that, depending on the length of the delay, "[a]n untimely disclaimer can constitute a waiver or estoppel of policy defenses."<sup>3</sup> A good example is *Griggs v. Bertram*, 443 A.2d 163 (N.J. 1982). There the New Jersey Supreme Court estopped a liability insurer from disclaiming coverage where the disclaimer came eighteen months after notice of the claim:

We . . . conclude that where, after timely notice, adequate opportunity to investigate a claim, and the knowledge of a basis for denying or questioning insurance coverage, the insurance carrier fails for an unreasonable time to inform the insured of a potential disclaimer, it is estopped from later denying coverage under the insurance policy . . .<sup>4</sup>

There are excellent reasons for penalizing insurers for prolonged delays in communicating coverage decisions:

Although an insurer may disclaim coverage for a valid reason...the notice of disclaimer must promptly apprise the claimant with a *high degree of specificity* of the ground or grounds on which the disclaimer is predicated. Absent such specific notice, a claimant might have difficulty assessing whether the insurer will be able to disclaim successfully. This uncertainty could prejudice the claimant's ability to ultimately obtain recovery. In addition, the insured's responsibility to furnish notice of a specific ground on which the disclaimer is based is not unduly burdensome, the insurer being highly experienced and sophisticated in such matters.<sup>5</sup>

An insurer's delay in disclaiming thus places the insured in the untenable position of not having coverage on the one hand, and not knowing why on the other. Such delays also impose on the insured the practical necessity of obtaining (or at least seeking) contractual "cover" for the insurer's delayed performance; but if the insured could comfortably cover on his own, he would not have needed insurance in the first instance.<sup>6</sup>

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3 BARRY R. OSTRAGER AND THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES §2.05(b)(1) (12th ed. 2004).

4 *Griggs*, 443 A.2d at 171.

5 *General Acc. Ins. Group v. Cirucci*, 387 N.E.2d 223, 225 (N.Y. 1979) (emphasis added).

6 See *E.I. duPont de Nemours and Co. v. Pressman*, 679 A.2d 436, 447 (Del. 1996) (observing that while "the non-breaching party can replace the performance of the breaching party" in most contractual settings, "[w]ith insurance this is simply not possible.")

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The requirement that insurers communicate timely disclaimers at risk of forfeiting coverage defenses – what may be termed the “no hindsight disclaimers” rule – has been the law of Delaware for the last sixty years:

It is a reasonable doctrine that an insurer be required promptly to disclose its purpose if it intends to rest its defense on a technical ground, a default which neither alters the risk nor increases the liability; and if it asserts other grounds of defense . . . it must assume the risk of having its conduct construed as an abandonment of other less meritorious defenses.<sup>7</sup>

More recently, the Superior Court reaffirmed the vitality of the “no hindsight” rule: “Counsel, *the law is clear in Delaware that if an insurer denies liability upon one ground, it may not later defend a suit upon another ground.*” *Thomas v. Harford Mut. Ins. Co.*, Del. Super., C.A. No. 01C-01-046HDR (April 8, 2004), hearing transcript at 3 (emphasis added).

Happily, we prevailed against ABC before it ever became necessary to brief the waiver issue. To understand why, we need to review the merits of ABC’s coverage denial carefully.

### Unreasonableness of the First Basis (The “Not an Insured” Defense)

Like most liability policies, the ABC policy set forth specific terms identifying who could qualify as an insured. Under that provision, any person using a vehicle with the named insured’s permission qualified as an additional insured for purposes of the policy’s “auto hazard.” There was never any dispute that the vehicle driven by young Mr. McDermott at the time of the collision was owned by his father (the named insured), and used with his father’s permission. ABC was aware of that fact from a number of sources, including the deposition testimony of both McDermotts.

There was thus no reasonable justification for ABC’s assertion that Mr. McDermott (the younger) was not an insured for purposes of the Smith claim.

### Unreasonableness of the Second Basis (The “No Legal Papers” Defense)

No alleged failure by Mr. McDowell to provide ABC with a copy of the Smith complaint could properly constitute a forfeiture of coverage. First, under *Sutch v. State Farm Mut. Auto. Ins. Co.*, 672 A.2d 17 (Del. 1995), an insured’s failure to supply legal papers to the insurer (in cases where the policy requires them to be supplied) is a garden-variety failure of notice. As such, it cannot operate as a forfeiture of coverage unless the insurer meets its burden of proving prejudice.<sup>8</sup> Under Delaware law, prejudice “*must be determined based upon loss of substance and not merely loss of opportunity for the insurer to follow its established procedures.*”<sup>9</sup> The insurer must thus show that “*evidence which it is reasonably*

*probable could have been developed by prompt investigation has not or cannot be developed by later investigation or that in some other respect it is reasonably probable that a resolution of the claim could have been reached if prompt notice had been given.*”<sup>10</sup>

ABC made no such showing. No witnesses had died, no documents had been lost, and ABC at all times possessed the information needed for its investigation. It has also been held that where (as here) the insurer is aware of the underlying lawsuit, but fails to alert the insured to the need to supply legal papers, the “no legal papers” defense is waived.<sup>11</sup> In this case, Ms. Smith’s attorney expressly invited ABC in August 2002 to request from him any information it felt might assist its coverage determination. ABC ignored this invitation for two years, apparently preferring to proceed without a copy of the complaint so that it could ultimately deny coverage on technical grounds.

In short, there was no reasonable justification for ABC’s denial of coverage on grounds of any alleged failure to supply it with a copy of the Smith complaint.

### Unreasonableness of the Third Basis (The “Schedule of Underlyings” Defense)

As discussed above, Mr. McDermott’s underlying auto policy had been exhausted by payment of its full \$500,000 policy limit toward the Smith claim. That \$500,000 limit was the precise amount identified in ABC’s Schedule of Underlying Insurance. ABC persisted in its denial nonetheless, contending that the \$500,000 policy could not constitute “underlying insurance” within the meaning of the ABC policy because it had not been expressly listed as such in ABC’s Schedule of Underlying Insurance.

But the term “underlying insurance” was a specially defined term under the ABC policy. That definition expressly included both policies *listed* in the Schedule of Underlying insurance, and policies *not so listed* – the latter having been described in the definition as “[a]ny other insurance available to the insured.” The ABC policy’s “auto hazard” coverage expressly employed this special definition of “underlying insurance”, so that an insured’s exhaustion of any available underlying insurance had to suffice. The exhaustion of the McDermotts’ underlying auto policy thus triggered coverage under ABC’s “auto hazard” provision.

This, indeed, is the position that ABC successfully argued in *ABC Ins. Co. v. Mac’s Septic Service*, 225 F. Supp.2d 595 (D. Md. 2002). There ABC’s summary judgment brief stated that “under the clear and unambiguous terms of the [policy], there is no auto liability coverage for bodily injury unless there is underlying coverage in the amount stated on the schedule . . . .” ABC thus argued that the

7 *Nathan Miller, Inc. v. Northern Ins. Co. of New York*, 39 A.2d 23, 26 (Del. Super. Ct. 1944).

8 *Sutch*, 672 A.2d at 21-22.

9 *Falcon Steel Co., Inc. v. Maryland Cas. Co.*, 366 A.2d 512, 517 (Del. Super. Ct. 1976).

10 *Id.*

11 *Crumley v. Travelers Indem. Co.*, 475 S.W.2d 654, 675-76 (Tenn. 1972).



essential characteristic needed to make an underlying policy "underlying insurance" under its commercial liability umbrella form is that the policy provide limits at least equal in amount to those specified in the Schedule – not that it actually be listed in the Schedule (a requirement that, again, would contradict the form's own definition of "underlying insurance"). The court agreed, allowing ABC to avoid coverage on that basis:

Thus, under the terms of the Auto Liability Limitation, the Umbrella Policy will not cover liability for bodily injury from an auto accident unless there is underlying liability coverage in the amount stated on the schedule, \$500,000, and then the umbrella coverage will be limited to the hazard coverage provided by the underlying insurance.

There was no reasonable justification for ABC's refusal to apply its own special definition of the term "underlying insurance" to the Smith claim; and no justification for ABC's contradicting its prior (successful) construction of the policy's terms.<sup>12</sup>

## The Lawsuit

We filed suit against ABC in Superior Court on June 24, 2005, pleading claims for declaratory judgment, breach of contract, bad faith breach of contract, statutory consumer fraud and intentional (or, more accurately, reckless) infliction of emotional distress. Simultaneously with the filing of the complaint we sent a letter to ABC's general counsel, setting forth our coverage analysis in detail and offering, for a limited time, an opportunity for ABC to settle. Our settlement demand required ABC to immediately pay the full \$1 million policy limit in order to avoid the risk of punitive damages on our claims for bad faith, consumer fraud and emotional distress.

ABC asked for more time to consider our coverage analysis. Not long after Labor Day 2005, it agreed to pay the \$1 million limit in full.

## Lessons Learned

Insurers of "personal lines" risks — the sellers of consumer insurance products in auto, health and homeowners insurance — frequently resort to technical defenses involving claims of late notice. In the case of the McDermotts, the technical defense was an alleged failure to supply a copy of underlying pleadings.

Such technical defenses should be challenged aggressively. The prevailing legal standards make it a rare case in which the insurer can properly avoid coverage based on a claim of late notice. Indeed, the "late notice" defense usually fails in all cases save those that may be characterized as *fait accompli* cases (as where an insurer with a duty to defend the underlying claim learns of the claim only after it has been tried to verdict).

A second lesson learned is that insurers who live by special definitions must sometimes die by them, too. Policyholders should not take any insurer's coverage analysis at face value, but should subject it to close scrutiny *through the prism of what the policy*

*actually says.* After all, if the drafter of a contract insists (for his own reasons) in defining "up" as "down" or "black" as "white", those special meanings must control the transaction.

A third lesson concerns the timing and content of coverage disclaimers. Many personal lines insurers, and auto insurers in particular, remain quite lax in the speed and precision with which they communicate coverage disclaimers.

No insurer, when provided with the essential facts needed to evaluate a claim, may properly wait a year or more before stating its position. In various cases across the country, delays of far less than one year have been held to constitute a waiver. Further, once the insurer finally denies coverage on specific stated grounds, it cannot properly litigate on the basis of other grounds not found in its disclaimer.

Policyholders should provide the insurer with as much information as possible as soon as possible; and then proceed to pursue the insurer aggressively for a prompt and definite written statement of its coverage position.

Finally, in insurance coverage as in all areas of the law, careful research is rewarded. The information age makes it more possible than ever to determine whether an insurer has taken prior inconsistent positions on the meaning of its own contract language (as ABC did here).

The overarching lesson, of course, is that despite the safeguards provided in contract law, established insurers still feel free to blithely ignore, and then wrongly deny, covered claims of profound importance. This time the ending was a happy one, because the insurer was ultimately forced to honor its contractual promises. But along the way, ABC subjected the McDermotts to years of uncertainty regarding the family's financial future, and left Ms. Smith deeply anxious as to whether and when she would ever be fairly compensated for her terrible loss. And there is nothing happy about that. ▲

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<sup>12</sup> Mac's Septic Service, 225 F. Supp.2d at 598.

