Enhancing the Socially Instrumental Role of Insurance: The Opportunity and Challenge Presented by the ALI *Restatement* Position on Breach of the Duty to Defend

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The American Law Institute (ALI), in its current draft of the Restatement of the Law of Liability Insurance*, has adopted the position that a liability insurer in breach of its duty to defend, but not acting in bad faith, forfeits the right to dispute coverage of the resulting judgment or reasonable, noncollusive settlement in a lawsuit. The ALI view is the minority rule in the courts in that most make bad faith a prerequisite for loss of a coverage defense but presumably will spur re-examination of the issue in many states. Unsurprisingly, insurers have opposed the ALI position with some vigor, arguing that forfeiture of coverage defenses is an unduly punitive measure that can improperly result in coverage beyond what the policyholder purchased. Insurers argue that traditional contract damages, primarily payment of the policyholder's defense costs, provide an adequate remedy. The debate tilts solidly in favor of the ALI if one takes a broad view of contract doctrine, and especially if one appreciates the purpose of liability insurance, the magnitude of a breached duty to defend, and the degree to which insurance involves not only a contract-based relationship between policyholder and insurer but also impacts the public at large. Insurance policies are not only contracts but products, private legislation, and social instruments serving a socioeconomic function for which insurer defense and resolution of claims is particularly important. It should be denied only in clear cases. By encouraging insurers to resolve close cases in favor of*

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defending, the ALI approach better serves the functional aspects of insurance.

INTRODUCTION

As everyone knows, an insurance policy is a contract, but it is different from typical contracts.[1] The particular role of insurance makes it one that should be less susceptible to reductionist, formalistic, or hyperliteral textual analysis than more typical contracts[2]—a situation that has not prevented contract formalists from

1. *See* ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW § 25A (4th ed. 2007) (treating insurance policies as contracts); JEFFREY W. STEMPEL ET AL., PRINCIPLES OF INSURANCE LAW § 2.01, at 99 (4th ed. 2011). Typical of judicial pronouncements on the topic is *Good v. Krohn*, 786 N.E.2d 480, 485 (Ohio Ct. App. 2002), in which the court stated: "It is well settled that an insurance policy is a contract and that the relationship between the insured and the insurer is purely contractual in nature." "This statement, although basically correct, glosses over a host of complexities of both insurance and contract." STEMPEL ET AL., *supra*.

2. Among the differences between insurance and a typical purchase are that the insurance policy is an aleatory contract in which the contractual exchange cannot be deemed equal, even if one accepts each party's valuation as conclusive. A policyholder may pay substantial premiums for decades and never submit a claim while, conversely, an insurer may be required to pay for catastrophic loss that far exceeds the premium paid only days after a policy takes effect. *See* EDWIN W. PATTERSON, ESSENTIALS OF INSURANCE LAW 62 (2d ed. 1957).

In addition, insurance policies are generally dramatically longer and more complex than most written instruments, even the occasionally baroque leases and chronically impenetrable credit card and mobile phone "agreements" inserted into monthly billings. The insurance policy is typically received weeks, or even months after the contract is made. In most cases, the insurer also has dramatically more bargaining power and expertise than the policyholder. Policyholders are also generally more vulnerable than other contracting parties in the event of breach. Where the insurer is charged with defending a suit complaining that courts depart too often from classic contract principles in construing insurance policies.[3]

The American Law Institute (ALI), in its *Restatement of the Law of Liability Insurance* (*Restatement*), has not rejected the contract model and has largely embraced it, albeit with occasionally significant interjections of public policy considerations.[4] The ALI project has been criticized from "the right" by insurers wishing to retain the protections afforded them by favorable judicial precedent. It has also been criticized from the figurative "left" as being insufficiently willing to recognize alternative characterizations of insurance policies that may profitably be brought to bear in construing policies. Instead, when the *Restatement* favors a position arguably at odds with the text of the insurance policy or prevailing precedent, it tends to do so on the basis of public policy considerations such as facilitating settlement, enhancing efficiency, or providing a more predictable or easily administered "rule," even if the rule is arguably in some tension with policy text.

Reduced deference to policy text can be justified, not only by public policy concerns or greater recognition of the limits of language but also by greater appreciation of the other identities of insurance policies, which not only are contracts but also operate in the nature of products,[5] private legislation crafted by

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against the policyholder, most jurisdictions regard the insurer as acting in a fiduciary capacity. *See* STEMPEL ET AL., *supra* note 1, at 99–107. Although these factors can exist for other contracts as well (e.g., a college student renting an apartment in Los Angeles), insurance appears to exhibit these departures from the classic bargaining model more often than most contractual agreements.

3. *See, e.g.*, David S. Miller, *Insurance as Contract: The Argument for Abandoning the Ambiguity Doctrine*, 88 COLUM. L. REV. 1849 (1988); Michael B. Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not Be Construed Against the Drafter*, 30 GA. L. REV. 171 (1995). *But see* Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996) (ambiguity principle central to insurance law).

4. The ALI project began in 2011 as the *Principles of the Law of Liability Insurance* and was only converted to a *Restatement* during Fall 2014. *See* Press Release, Am. Law Inst., The American Law Institute Changes Two Principles Projects to Restatements (Nov. 11, 2014) (on file with the UC Irvine Law Review) ("ALI Director Richard Revesz explained, 'As these two projects have been coming together, we realized that the content was much more like a Restatement than the typical Principles projects produced by ALI. A Restatement is generally addressed to the courts and clarifies existing law. We feel these projects are more properly classified as Restatements.'").

The difference between publishing a *Restatement* and publishing *Principles* is not particularly pronounced. The primary distinction is that a *Restatement* is focused primarily on stating what the law is, albeit with recognition of minority and majority rules and commentary, while a *Principles* project is viewed as less bound by the strict letter of the law. *See* AM. LAW INST., CAPTURING THE VOICE OF THE AMERICAN LAW INSTITUTE: A HANDBOOK FOR ALI REPORTERS AND THOSE WHO REVIEW THEIR WORK 4–14 (2005) [hereinafter ALI HANDBOOK]. To the extent the difference is meaningful, a *Principles* of insurance document is logically less cabined by the actual law than is a *Restatement*; as a practical matter, the difference is probably only one of degree.

5. *See* Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389 (2007); Jeffrey W. Stempel, *The Insurance Policy as Thing*, 44 TORT TRIAL & INS. PRAC. L.J. 813 (2009).

One court decision invoking a strong form of the reasonable expectations approach to resolving insurance coverage disputes noted the product-like nature of insurance by using an implied warranty analogy, but this metaphor failed to catch on. *See, e.g.*, C & J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W.2d 169, 177–79 (Iowa 1975) ("[P]olicy [of burglary insurance with requirement of visible marks of the insurance industry and essentially imposed on most policyholders,[6] and purposive instruments designed to accomplish particular functions in the real world.[7] Construction of insurance policies—and the relationship between insurers, policyholders, claimants, and the public—can be substantially enriched by recognizing these alternative characterizations of insurance policies. The socioeconomic role of insurance, in particular, can be a valuable lens for assessing insurance policies and adjudicating their operation.

In addition to being a contract between policyholder and insurer, the insurance policy has a number of other important identities, most interestingly as a "social instrument" or "social institution" that serves to facilitate socioeconomic activity. For that reason, various issues of insurance policy construction should be addressed not only according to the text of the insurance policy at issue or any specific documented intent of the parties, but also according to the overarching purpose of the policy and the socioeconomic role played by the policy, both as between the parties and in relation to society at large.[8]

Appreciating this aspect of insurance provides useful guidance when addressing issues of insurer conduct and the consequences of that conduct. Unless

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forced entry] provided by defendant in this instance breached the implied warranty of fitness for its intended purpose. It altered and impaired the fair meaning of the bargain these parties made for plaintiff's insurance protection.") (suggesting an insurance policy may be in breach of an implied warranty of fitness for particular purpose where text in policy would reduce coverage below what is reasonably expected by typical policyholders).

But only a handful of cases have cited *C & J Fertilizer*'s warranty language. Most decisions in this vein do not expressly invoke the breach-of-warranty concept. *See, e.g.*, Great Lakes Chem. Corp. v. Int'l Surplus Lines Ins. Co., 638 N.E.2d 847, 850 (Ind. Ct. App. 1994) (where policy text is seemingly clear but results only in illusory coverage, court will construe policy to comport with policyholder's reasonable expectations); Prudential Ins. Co. v. Lamme, 425 P.2d 346, 347 (Nev. 1967) (complexity of insurance policies and comparative expertise and sophistication of insurer may require that courts not be bound by "strict legal [contract] doctrine" in construing a policy or conditional receipt (citing Allen v. Metro. Life Ins. Co., 208 A.2d 638, 644–45 (N.J. 1965)), which found coverage in part because a reasonable policyholder paying premium at time of sale would reasonably presume to be immediately covered even though the text of the conditional receipt given in return for payment required underwriting by insurer before coverage could attach).

The reasonable expectations approach or "doctrine," in its strongest form, finds coverage consistent with the objectively reasonable expectations of the policyholder, even though close examination of the policy text might have negated those expectations. *See* Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 967 (1970). Few courts have applied the reasonable expectations principle in such strong form, however. Although courts often construe disputed text in a manner consistent with policyholder expectations (*see, e.g.*, Bird v. St. Paul Fire & Marine Ins. Co., 120 N.E. 86, 87–88 (N.Y. 1918), an influential opinion by then-Judge Benjamin Cardozo), the vast majority of state versions of the approach require that the disputed text first be deemed ambiguous before expectations analysis is deployed in favor of the policyholder. *See* RANDY J. MANILOFF & JEFFREY W. STEMPEL, GENERAL LIABILITY INSURANCE COVERAGE: KEY ISSUES IN EVERY STATE, ch. 22 (2d ed. 2012); *see, e.g.*, Liggatt v. Emp'rs Mut. Cas. Co., 46 P.3d 1120, 1127 (Kan. 2002); Burns v. Smith, 303 S.W.3d 505, 512 (Mo. 2010).

6. *See* Jeffrey W. Stempel, *The Insurance Policy as Statute*, 41 MCGEORGE L. REV. 203 (2010).

7. *See* Jeffrey W. Stempel, *The Insurance Policy as Social Instrument and Social Institution*, 51 WM. & MARY L. REV. 1489 (2010).

8. *See generally id.*

foreclosed by specific agreement of the parties or other powerful countervailing considerations, this perspective counsels in favor of courts requiring requisitely appropriate behavior by insurers toward policyholders, claimants, regulators, and the legal community.

An important illustration is presented by the question of whether a liability insurer that breaches its duty to defend thereby loses the ability to contest coverage. Courts and commentators are divided, with a majority permitting insurers to breach the duty and yet still contest coverage so long as the breach was not so unreasonable as to constitute bad faith.[9] The contrary *Restatement* position prompted the insurance industry to oppose the proposal on the eve of its consideration at the 2014 ALI Annual Meeting.[10]

Notwithstanding this opposition, the May 2014 ALI Meeting voted in overwhelming support of the draft *Restatement* position: where a liability insurer erroneously refuses to defend a policyholder (or provides an incompetent or inadequate defense), the insurer not only must pay damages, such as the policyholder's defense costs and incidental or consequential damages, but also must be bound to provide coverage for the resulting judgment or a reasonable, noncollusive settlement.[11] In other words, the insurer in breach of the duty to defend loses the right to contest coverage even if the breach was not in bad faith.[12]

Although insurance industry opposition to the *Restatement* has some support under traditional contract law, it is clearly a weak argument when viewed through the lens of the insurance policy's identity as a social instrument or social institution. Liability insurance is designed to provide "litigation insurance" to the policyholder. The defense aspect of a liability insurance policy is often just as important or more important than the indemnity aspect of the policy.[13] In addition, prompt and

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9. *See* cases dividing on this issue cited *infra* note 28.

10. For example, on the eve of the March 2014 Meeting of the Advisors of the *Restatement*, each received via FedEx a letter brief arguing against the draft position along with copies of judicial decisions permitting an insurer in breach of the duty to defend to nonetheless contest coverage.

11. *See* Am. Law Inst., *Annual Meeting*, 91 A.L.I. PROC. 201–09 (2014) [hereinafter ALI PROCEEDINGS 2014] (during presentation of *Liability Insurance Principles* (now *Restatement*) motion to amend section 21 to reject forfeiture of coverage defenses as consequence of breach of duty to defend rejected by voice vote); Am. Law. Inst., *Actions Taken at the 91st Annual Meeting*, A.L.I. (May 20, 2014), http://2014annualmeeting.org/actions-taken [http://perma.cc/S2NN-Q9H5] ("Several motions to amend sections dealing with the insurer's right to contest coverage, its duty to defend, and its duty to make reasonable settlement decisions were defeated or withdrawn, and the members voted to approve Tentative Draft No. 2, subject to the discussion at the Meeting and to the usual editorial prerogative.").

12. Almost all jurisdictions hold that an insurer acting in bad faith in failing to adequately defend or settle a matter is not only bound by the result in the underlying matter but is also required to provide liability/indemnity coverage up to the policy limits and often for the entire result in the underlying matter, even if it exceeds policy limits.

13. *See* Marc S. Mayerson, *Insurance Recovery of Litigation Costs: A Primer For Policyholders and Their Counsel*, 30 TORT & INS. L.J. 997, 1014 (1995) ("Policyholders for decades have paid for defense coverage under their liability insurance policies. This 'litigation insurance'—insurance against the expense and burden of defending claims—is a very valuable asset of policyholders."); *see also* MANILOFF & STEMPEL, *supra* note 5, at 89 (because of importance of defense aspects of liability insurance, "[i]f coverage issues were stocks, the duty to defend would be Blue Chip").

competent involvement of the insurer in defense and adjustment of a claim against the policyholder facilitates more effective victim compensation and efficient dispute resolution.

When the insurer—an expert and ultimate repeat player in the business of litigation management[14]—fails to properly shoulder its duty to defend based on the "potential for coverage" standard that governs determination of the duty, this has significant negative impact on policyholders, victims, courts, and society at large. Examining the issue of remedies for breach of the duty to defend through the lens of a broader concept of the insurance policy vindicates the ALI proposal and argues for its adoption by the courts. The social instrument function of liability insurance provides particularly strong support for the ALI position.

I. THE DUTY TO DEFEND AND APPROACHES TO ITS BREACH

The standard general liability policy gives the insurer the right and duty to defend claims. As is oft stated in the case law, the duty to defend is "broader" than the duty to pay claims in that the duty to pay is based on the actual determination of coverage under the facts of the case as adjudicated, while the duty to defend is based on the "potential" for coverage based upon the allegations of the plaintiffs' complaint (the so-called "four corners," or in some jurisdictions "eight corners," test based upon comparison of the face of complaint and the face of the policy).[15]

In addition, if the insurer is aware of facts outside the four corners of the complaint that create a potential for coverage, most states deem the duty to defend to be triggered.[16] However, the converse is not usually true. Even if the insurer has rather strong evidence that could eliminate the prospect of coverage, most courts find that the duty to defend, triggered by a four-corners analysis, to remain in effect until such time as the insurer's factual evidence contradicting plaintiff's complaint is adjudicated to be correct.[17]

Where a duty to defend is triggered, but there exist questions as to the actual facts of an incident or issues as to the meaning of contested coverage terms, insurers normally err on the side of safety and defend under reservation of rights, even though this may give policyholders a right to choose independent counsel, which in turn can create issues of the rate at which the insurer must pay for counsel chosen

14. The terminology (and perhaps even the concept) of "one-shot" and "repeat players" in litigation and the attendant advantages enjoyed by the latter group stems from Marc Galanter's important article. *See* Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC'Y REV. 95, 97–98 (1974). Liability insurers are paradigmatic repeat players who are by definition in the business of managing tort litigation against policyholders and related litigation concerning coverage of such claims.

15. *See* MANILOFF & STEMPEL, *supra* note 5, ch. 5.

16. *See id.* at 90–92.

17. *See, e.g.*, Andrew v. Century Sur. Co., No. 2:12-cv-00978-APG-PAL, 2014 U.S. Dist. LEXIS 60972 (D. Nev. Apr. 29, 2014). In this case, the complaint alleged that the tortfeasor was working at the time of auto the accident, triggering coverage under the employer's policy. The tortfeasor repeatedly told investigators that he was off work at the time of the accident. The court found potential for coverage and a duty to defend under state law, embracing the four corners approach.

by the policyholder.[18] Whatever the potential problems for an insurer providing a defense under reservation of rights, it at least gives the insurer a relatively safe harbor. In this safe harbor, the insurer can avoid any penalties or damages for failure to defend and as a practical matter reduce exposure to allegations of bad faith (although unreasonable failure to settle or other mistreatment of the policyholder could still result in bad faith liability).

Another frequent insurer response is commencement of a declaratory judgment action, particularly when defending claims in which potential coverage is created by the complaint, but information suggests the actual facts may be to the contrary.[19] Pursuing a declaratory judgment action as a defense is a common means by which the insurer protects itself from being accused of breach or bad faith behavior while seeking a favorable resolution, which may avoid payment of years of expensive litigation costs.[20]

II. PREVAILING REMEDIES REGARDING BREACH OF THE DUTY TO DEFEND

Notwithstanding the favorability of the duty to defend doctrine for policyholders and the available protections of defense under reservation and declaratory judgment, insurers still erroneously refuse to defend claims. When this occurs, the policyholder, forced to defend itself, is at least entitled to recovery of the reasonable amounts spent on defense (both counsel fees and other reasonable defense expenditures, as well as any incidental or consequential damages proximately flowing from the breach).[21] Pursuant to basic, uncontested contract

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18. *See* MANILOFF & STEMPEL, *supra* note 5, ch. 6.

19. *See* JERRY & RICHMOND, *supra* note 1, § 111; MANILOFF & STEMPEL, *supra* note 5, at 92–94.

20. *See* JEFFREY W. STEMPEL, STEMPEL ON INSURANCE CONTRACTS § 9.03[c], at 9-113 (3d ed. 2006 & Supp. 2015) (when disputing duty to defend, insurer normally "not only inform[s] the policyholder in writing of its decision to decline coverage and defense but also commence[s] a declaratory judgment action, using discovery and trial if necessary to establish as unquestionable fact the grounds for its denial"); *see also* ALI PROCEEDINGS 2014, *supra* note 11, at 207 (comments of Professor Jeffrey Thomas) (noting common use of declaratory judgment actions by insurers disputing duty to defend).

21. Although it is widely agreed that an insurer in breach of the duty to defend must ultimately at least pay for a defense of the policyholder, there can be significant disagreement about the amount that must be paid for defense and the mechanics of the process. When an insurer defends, it ordinarily retains panel counsel and pays according to its normal compensation arrangements with counsel.

Where insurer and policyholder have a conflict of interest, the policyholder normally may choose its own independent counsel. In these situations, a dispute often arises regarding the rate of payment to counsel. Commercial insureds typically pay a higher hourly rate to their regular commercial lawyers than insurers do to panel counsel, creating some tension. States have various approaches to the problem, but most follow a method akin to California's approach, which provides that the insurer must pay for the policyholder's chosen independent counsel, but only up to the rate it normally pays panel counsel for similar work. There can still be debate as to what constitutes "similar work," but this is a relatively clear ground rule otherwise. *See* MANILOFF & STEMPEL, *supra* note 5, ch. 6.

The ALI *Restatement* draft (section 19), as written at the time of the 2014 ALI Annual Meeting, adopted the view that when there is controversy between insurer and policyholder over this issue, the policyholder may obtain independent counsel of its choosing, with the insurer paying counsel fees at chosen counsel's normal rate during the pendency of resolution of any dispute over the apt rate of law, these latter damages must be proven with reasonable certainty.[22] "The compensatory damages recoverable in some states include consequential damages and attorneys' fees incurred in an action commenced to enforce the defense obligation. Consequential damages are 'those that cannot be reasonably prevented and arise naturally from the breach, or which are reasonably contemplated by the parties.'"[23]

Absent unusual situations, *Restatement* section 21 is not controversial in stating that breaching insurers are liable for basic damages such as defense costs incurred by policyholder and other provable incidental and consequential damages.[24] *Restatement* section 21 is also uncontroversial in providing that an insurer breaching

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payment. If the policyholder prevails, no money changes hands. If the insurer prevails, the policyholder must reimburse the insurer for the difference between chosen counsel's rate and the reasonable rate determined by the court. This aspect of the draft received significant criticism on the ground that it placed too much burden on the insurer to pay even counsel rates obviously higher than prevailing rates for defense of such cases by counsel typically retained by insurers, as well as raising concerns over recovery of such costs and creating unnecessary reimbursement litigation. In response, the Reporters of the *Restatement* agreed to reconsider this section.

22. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 5.06[a], at 440–41 (16th ed. 2013) ("Because the 'duty to defend' is a contractual obligation, an insured can recover compensatory damages for an insurer's breach of its defense obligations.").

23. *Id.* at 441 (citations omitted); *see also* J. Robert Hall, *Considering the Duty to Defend*, *in* 1 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE § 11A.29 (Jeffrey E. Thomas et al. eds., 2015) ("Generally, and absent a finding of insurer bad faith, the damages an insured may recover based on a breach of the insurer's duty to defend are the reasonable and necessary attorney's fees and costs that the insured incurs in providing for its own defense."). The principle underlying consequential damages is derived from the well-known case of *Hadley v. Baxendale*, 156 Eng. Rep. 145 (Ex. 1854). *See* RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981); E. ALLAN FARNSWORTH, CONTRACTS § 12.14, at 260 (3d ed. 2004) ("[P]arty need only have been given notice of fact that made it [loss or injury] foreseeable.").

As a note, the hedging statement in the treatise ("in some states") is probably not necessary. All states purport to follow traditional contract doctrine, which permits recovery of incidental and consequential damages for breach of contract case and would logically extend to any breach of an insurance contract. *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 ("[Party injured by breach has a right to] his expectation interest as measured by (a) the loss in the value to him of the other party's performance caused by its failure or deficiency, plus (b) any other loss, including incidental or consequential loss, caused by the breach, less (c) any cost or other loss that he has avoided by not having to perform.").

But beyond the costs of defending the lawsuit that should have been defended by the insurer, the policyholder may have difficulty establishing other damages besides the costs of litigating with the insurer over coverage. States are divided over whether to permit recovery of counsel fees in a matter of ordinary breach. *See* MANILOFF & STEMPEL, *supra* note 5, ch. 8. A significant number of states permit recovery of counsel fees to a policyholder who prevails in a declaratory judgment coverage action. *See, e.g.*, Mountain W. Farm Bureau Mut. Ins. Co. v. Brewer, 69 P.3d 652, 657–58 (Mont. 2003); Olympic S.S. Co. v. Centennial Ins. Co., 811 P.2d 673, 681 (Wash. 1991). And all states appear to permit such recovery where there is insurer bad faith, although in many cases the state high courts have not rendered definitive decisions. *See* Michael F. Aylward, *Understanding Bad Faith*, *in* 1 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE § 6.21 (Jeffrey E. Thomas et al. eds., 2015); *see, e.g.*, Brandt v. Superior Court, 693 P.2d 796, 797 (Cal. 1985) (where insurer has acted tortuously, i.e., in bad faith, policyholder may recover counsel fees); Allstate Ins. Co. v. Huzar, 52 P.3d 816, 821–22 (Colo. 2002) (where insurer position groundless, policyholder may recover fees).

24. *See* RESTATEMENT (SECOND) OF CONTRACTS § 21 (1981).

the duty to defend loses its rights of defense, control, or settlement.[25] By definition, an insurer that has refused to take the field no longer has the right to coach the defense team or decide when and how to resolve a claim against the policyholder. If the undefended policyholder settles the case, the amount and terms of the settlement will generally be binding on the erroneously nondefending insurer so long as it was reasonable and not the product of policyholder collusion with the plaintiff.[26]

III. THE DIVISION OVER BARRING THE NONDEFENDING INSURER FROM DISPUTING COVERAGE

Although the *Restatement* approach is the clear "minority" rule, obtaining an exact "scorecard" of the states on this issue can be difficult because of the absence of definitive authority in many states.[27] Commentators may have overstated the strength of this "majority" rule[28] of permitting the insurer to breach the defense duty and continue to retain the right to dispute coverage.[29] But without doubt, the

25. *See* Hall, *supra* note 23, § 11A.32 ("[e]ven in jurisdictions that do not apply the contractual estoppel doctrine" barring coverage defenses for the erroneously nondefending insurer, "the insured often is no longer bound by policy conditions, including but not limited to" cooperation, refraining from voluntary payments, or avoiding impairment of subrogation rights).

26. *See id.*; Seth D. Lamden, *Duty to Defend*, *in* 3 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 17.07 (Jeffrey E. Thomas et al. eds., 2009 & Supp. 2014) (insurer in breach of duty to defend loses contractual right to control defense and settlement of the action, must pay defense costs incurred by policyholder, and is bound by reasonable, noncollusive settlement entered into by policyholder and plaintiff; courts divide over whether insurer forfeits coverage defenses or must pay policyholder's counsel fees in litigating coverage with insurer).

For general discussion of the duty to defend and remedies for breach, see STEPHEN S. ASHLEY, BAD FAITH ACTIONS LIABILITY & DAMAGES § 4:7 (2d ed. 2014); JERRY & RICHMOND, *supra* note 1, § 111; OSTRAGER & NEWMAN, *supra* note 22; IRVIN E. SCHERMER & WILLIAM SCHERMER, 1 AUTOMOBILE LIABILITY INS. § 14:3 (4th ed. 2010); STEMPEL, *supra* note 20, § 9.03; LEE R. RUSS & THOMAS F. SEGALLA, 4 COUCH ON INSURANCE § 51:73 (3d ed. 2011); ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4:36–38 (6th ed. 2013 & Supp. 2014); William T. Barker, *Duties Under Liability Insurance Policies: Duty to Defend*, *in* 1 NEW APPLEMAN LAW OF LIABILITY INSURANCE § 6.03 (2d ed. 2014); Lamden, *supra*, § 17; Susan Randall, *Redefining the Insurer's Duty to Defend*, 3 CONN. INS. L.J. 221, 254–66 (1997) (presenting public policy considerations on issue).

27. *See, e.g.*, Flannery v. Allstate Ins. Co., 49 F. Supp. 2d 1223, 1227 (D. Colo. 1999) (identifying forfeiture of coverage defenses as the minority rule but not providing exact tally); ASHLEY, *supra* note 26 (same); Lamden, *supra* note 26, § 17.07[3][b] ("majority of jurisdictions" permits breaching insurer to raise coverage defenses, but citing only three cases although citing no examples of minority rule).

28. Randy J. Maniloff, *ALI Principles of Insurance Should Concern Industry*, LAW 360 (Apr. 16, 2014), http://www.law360.com/articles/528384 (on file with the UC Irvine Law Review) (asserting that "[w]aiver of coverage defenses is a very strong—punitive you might say—consequence for a breach of the duty to defend" and is "not the law in the vast majority of states" but not citing cases); *see also* Hall, *supra* note 23, § 11A.29 ("majority rule" is that policyholder damages from breach of duty to defend are, absent bad faith, usually only the reasonable and necessary defense costs incurred that should have been paid by the insurer but citing only three cases as illustrative); *id.* § 11A.32 (only "small minority" of states strip nondefending insurers of coverage defenses; it is a "distinct minority" position). *But see* JERRY & RICHMOND, *supra* note 1, at 861 (refraining from taking position).

29. WINDT, *supra* note 26, § 4:37 (stating that the "vast majority of cases have properly held that an insurer's unjustified refusal to defend does not estop it from later denying coverage under its duty to indemnify"; majority rule and apt remedy is payment of defense costs, (in some states) counsel fees,

bulk of jurisdictions appear to hold this view,[30] creating a conflict between the ALI proposal and the status quo.

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and other provable consequential damages). One treatise does not acknowledge even the existence of the minority rule favoring loss of coverage defenses for breach of the duty to defend. *See* OSTRAGER & NEWMAN, *supra* note 22, § 5.06[a] (making no mention of split in states and citing Louisiana Supreme Court case permitting coverage defenses after breach as sole authority on the topic).

A 2005 state-by-state survey conducted by the Defense Research Institute (DRI) lists twenty-two states as following the traditional or majority rule and eight states as adopting the minority rule or ALI position. *See generally* DRI, DEF. LIBRARY SERIES, THE INSURER'S DUTY TO DEFEND: A COMPENDIUM OF STATE LAW (2005). But intervening developments and a still ongoing closer look at case law has already led me to revise the figures to nineteen and eleven, respectively. *See* RANDY J. MANILOFF & JEFFREY W. STEMPEL, GENERAL LIABILITY INSURANCE: KEY ISSUES IN EVERY STATE, ch. 23 (3d ed. 2015). Without doubt, a clear majority of jurisdictions align with insurers on this issue, but the scorecard is perhaps not so overwhelming that it should enjoy deference in light of the ALI position.

30. *See* MANILOFF & STEMPEL, *supra* note 5 (a detailed listing and discussion of state-by-state division over this issue); *see also* Polaroid Corp. v. Travelers Indem. Co., 610 N.E.2d 912, 922 (Mass. 1993) ("The statement made by some courts that the insurer is estopped to deny liability is simply a conclusion and fails to recognize that no estoppel is involved in any traditional sense because, in refusing to defend a claim, an insurer makes no misrepresentation on which the insured relies to its detriment."); *id.* at 922 n.22 (providing that an insurer in breach of the defense duty suffers some limits on its ability to contest coverage in that the failure to defend creates a rebuttable presumption of coverage and that the insurer bears the burden of proof on coverage issues).

Compare (states and cases permitting insurer in breach of the duty to defend to nonetheless contest coverage): Royal Ins. Co. of Am. v. Kirksville Coll. of Osteopathic Med., 304 F.3d 804, 807 (8th Cir. 2002) (applying Missouri law); Signature Dev. Cos. v. Royal Ins. Co. of Am., 230 F.3d 1215, 1222 (10th Cir. 2000) (applying, predicting Colorado law on this point); Spencer v. Assurance Co. of Am., 39 F.3d 1146, 1149 (11th Cir. 1994) (applying Florida law); Ala. Hosp. Ass'n Trust v. Mut. Assurance Soc'y of Ala., 538 So. 2d 1209, 1216 (Ala. 1989); Capstone Bldg. Corp. v. Am. Motorists Ins. Co., 67 A.3d 961, 999 (Conn. 2013); S. Guar. Ins. Co. v. Dowse, 605 S.E.2d 27, 29 (Ga. 2004); Sentinel Ins. Co. v. First Ins. Co. of Haw., 875 P.2d 894, 912–13 (Haw. 1994); Hirst v. St. Paul Fire & Marine Ins. Co., 683 P.2d 440, 447 (Idaho Ct. App. 1984); Foreman v. Jongkind Bros., 625 N.E.2d 463, 468 (Ind. Ct. App. 1993); Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co., 104 P.3d 997, 1005 (Kan. Ct. App. 2005); Cincinnati Ins. Co. v. Vance, 730 S.W.2d 521, 523 (Ky. 1987) (insurer in breach responsible for ordinary contract damages, but may contest coverage); Arceneaux v. Amstar Corp., 66 So. 3d 438, 452 (La. 2011) ("[R]emedy [of loss of coverage defenses] created by the lower courts in this case judicially imposes a result that would permit insureds to reap a windfall of potentially enormous profits, far beyond the natural consequences of the insurer's bad faith breach of the duty to defend, and far beyond the scope of the insurer's contractual undertaking."); Elliott v. Hanover Ins. Co., 711 A.2d 1310, 1313 (Me. 1998); Mesmer v. Md. Auto. Ins. Fund, 725 A.2d 1053, 1058 (Md. 1999) (no loss of coverage defenses for breach of the duty to defend; remedy for breach is payment to insured of counsel fees, costs, and interest); St. Paul Ins. Co. v. Bischoff, 389 N.W.2d 443, 445 (Mich. Ct. App. 1986) (nondefending insurer may contest coverage); Alton M. Johnson Co. v. M.A.I. Co., 463 N.W.2d 277, 279 (Minn. 1990); Engeldinger v. State Auto. & Cas. Underwriters, 236 N.W.2d 596, 602 (Minn. 1975); A.B.C. Builders, Inc. v. Am. Mut. Ins. Co., 661 A.2d 1187, 1191 (N.H. 1995) (insurer's breach of defense duty "should not be used as a method of obtaining coverage for the insured that the insured did not purchase"); K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co., 6 N.E.3d 1117, 1120 (N.Y. 2014); Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford, 477 N.E.2d 441, 444 (N.Y. 1985); First Bank of Turley v. Fid. & Deposit Ins. Co. of Md., 928 P.2d 298, 306 (Okla. 1996); Timberline Equip. v. St. Paul Fire & Marine Ins. Co., 576 P.2d 1244, 1248 (Or. 1978) (insurer breaching duty to defend must pay damages flowing form the defense breach, but retains right to contest coverage); Gedeon v. State Farm Mut. Auto. Ins. Co., 188 A.2d 320, 322 (Pa. 1963); Summerhaze Co. v. Fed. Deposit Ins. Co, 332 P.3d 908, 921 (Utah 2014); Gibbs M. Smith, Inc. v. U.S. Fid. & Guar. Co., 949 P.2d 337, 344 (Utah 1997) (where insurer fails to defend claim, insured may settle without insurer's consent but insurer may contest coverage and

IV. THE ALI PROPOSAL

This issue, which has divided courts and commentators as well as counsel representing insurers and policyholders, began to receive renewed attention in 2013 and 2014 because of the draft *Restatement* and a New York high court case presenting the issue.[31]

The *Restatement* (while still the *Principles* project) addressed the duty to defend and its consequences in Tentative Draft No. 2 of the Project, which was approved by the Institute at its May 2014 Annual Meeting.[32] Regarding the effect of breach

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reasonableness of the settlement); *and* Blake v. Nationwide Ins. Co., 904 A.2d 1071, 1077 (Vt. 2006), *with* (states and cases barring insurer in breach of the duty to defend from contesting coverage): Twin City Fire Ins. Co. v. City of Madison, Miss., 309 F.3d 901, 906 (5th Cir. 2002) (applying Mississippi law) (breach of duty to defend precludes insurer from raising defenses to coverage); Progressive Cas. Ins. Co. v. Skin, 211 P.3d 1093, 1103 (Alaska 2009); Lloyd's & Inst. of London Underwriting Cos. v. Fulton, 2 P.3d 1199, 1209 (Alaska 2000); Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust, 708 N.E.2d 1122, 1135 (Ill. 1999) ("Once the insurer breaches its duty to defend . . . the estoppel doctrine has broad application and operates to bar the insurer from raising policy defenses to coverage, even those defenses that may have been successful had the insurer not breached its duty to defend."); Farmers Union Mut. Ins. Co. v. Staples, 90 P.3d 381, 387–89 (Mont. 2004) (insurer's breach of duty to defend bars insurer from raising coverage defenses); Burd v. Sussex Mut. Ins. Co., 267 A.2d 7, 13 (N.J. 1970); State Farm Fire & Cas. Co. v. Farmers Alliance Mut. Ins. Co., 96 P.3d 1179, 1184–85 (N.M. Ct. App. 2004); Ames v. Cont'l Cas. Co., 340 S.E.2d 479, 485 (N.C. Ct. App. 1986) ("When an insurer without justification refuses to defend its insured, the insurer is estopped from denying coverage . . . ."); Sanderson v. Ohio Edison Co., 635 N.E.2d 19, 24 (Ohio 1994) ("Fairness and justice demand that an insurer that breaches its duty to defend an insured be estopped from asserting" coverage defenses); Conanicut Marine Servs., Inc. v. Ins. Co. of N. Am., 511 A.2d 967, 971 (R.I. 1986); Truck Ins. Exch. v. VanPort Homes, Inc., 58 P.3d 276, 279 (Wash. 2002) (insurer breaching duty to defend loses right to contest coverage and is bound by result in underlying case, including settlement, so long as settlement is reasonable and not fraudulent or collusive); Appleton Papers, Inc. v. Agric. Ins. Co., 727 N.W.2d 373, ¶ 11-12 (Wis. Ct. App. 2006) (breach of duty to defend forfeits coverage defenses and binds insurer to results in underlying case, including reasonable settlement); *and* Radke v. Fireman's Fund Ins. Co., 577 N.W.2d 366, 371 (Wis. Ct. App. 1998) ("When an insurer wrongfully refuses to defend on the grounds that a claim against its insured is not within the coverage of the policy, the insurer cannot later contest coverage, but is liable to the insured.").

Texas law appears mixed on the issue. *Compare* Evanston Ins. Co. v. Atofina Petrochemicals, Inc., 256 S.W.3d 660, 675 (Tex. 2008) (insurer breaching duty to defend loses right to contest coverage), *with* Utica Nat'l Ins. Co. of Tex. v. Am. Indem. Co., 141 S.W.3d 198, 203 (Tex. 2004) (even if insurer breaches duty to defend, policyholder must still prove entitlement to coverage and insurer may dispute coverage).

Several states (Arizona, Arkansas, Delaware, District of Columbia, Iowa, Nebraska, Nevada, North Dakota, South Carolina, South Dakota, Tennessee, Virginia, West Virginia, Wyoming) lack definitive authority or have conflicting authority. Other jurisdictions (e.g., California) are not particularly clear, but appear to permit nondefending insurers to contest coverage.

Regarding recovery of counsel fees where there is coverage litigation, the states also divide as to whether a prevailing policyholder may obtain an award of counsel fees from the insurer that erroneously denied coverage but did not act in bad faith (all states appear to permit fee awards against an insurer acting in bad faith). *See generally* MANILOFF & STEMPEL, *supra* note 5, ch. 8.

31. Regarding the ALI process for producing a *Restatement*, which usually takes several years, see ALI HANDBOOK, *supra* note 4, at 14–19 (The Drafting Cycle). Regarding renewed attention, see, for example, *supra* text accompanying note 28 (sources discussing controversy) and discussion *infra New York's Recent About-Face on the Issue* (case presenting the issue).

32. PRINCIPLES OF THE LAW OF LIAB. INS. § 21 (Tentative Draft No. 2, 2014).

of the duty to defend, section 21—which has been the primary locus of controversy—provides:

> § 21. Consequences of Ordinary Breach of the Duty to Defend
>
> (1) A liability insurer that breaches the duty to defend a claim loses the right to defend or associate in the defense of the claim, the right to assert any control over the settlement of the claim, *and the right to contest coverage for the claim.*
>
> (2) Damages for breach of the duty to defend include the amount of any *judgment entered into against the insured or the reasonable portion of a settlement entered into by or on behalf of the insured after breach, subject to the policy limits, and the reasonable defense costs incurred by or on behalf of the insured*, in addition to any other damages recoverable for breach of a liability insurance contract. The insurer bears the burden of proof that any amount of any settlement or defense costs is unreasonable.
>
> (3) The insured may assign to the claimant or to an insurer that takes over the defense of all or part of any cause of action for breach of the duty to defend the claim.[33]

As discussed above, nearly everyone agrees (and it logically follows) that if there is an incorrect refusal to defend, the policyholder forced to defend itself is at least entitled to recovery of the reasonable amounts spent on defense (both counsel fees and other reasonable defense expenditures as well as any incidental or consequential damages proximately flowing from the breach), provided they are proven with reasonable certainty.[34] ALI *Principles* section 21 is not controversial in stating that breaching insurers are liable for basic damages such as defense costs incurred by policyholder.[35]

An insurer breaching the duty to defend loses its rights of defense, control, or settlement. If the undefended policyholder settles the case, the amount and terms of the settlement will generally be binding on the erroneously nondefending insurer so long as it was reasonable and not the product of policyholder collusion with the plaintiff.[36] Most courts, even those permitting the insurer to contest coverage, do not permit the insurer to avoid the settlement unless it can bear the burden of proving the settlement was unreasonable or the product of collusion.[37]

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33. *Id.* (emphasis added). This language continues in Preliminary Draft No. 1 of the *Restatement* (2015), which is the current working manuscript of the *Restatement* and is available at ali.org.

34. *See supra* notes 21–24 and accompanying text.

35. *See* ALI PROCEEDINGS 2014, *supra* note 11, at 190–235 (vigorous debate about portions of *Restatement*, particularly section 21 provision providing for forfeiture of coverage defenses where duty to defend is breached, but no argument that insurer in breach of duty must reimburse policyholder for reasonable defense costs and other incidental and consequential damages stemming from breach).

36. *See id.* (no debate that erroneously undefended policyholder may protect itself through reasonable settlement, albeit some division of membership as to protocol for gauging reasonableness of settlement); *see also infra* note 37.

37. *See* BARKER, *supra* note 26, § 6.03 ("If the insurer breaches the duty to defend, it will be bound as to the fact and amount of the insured's liability, even if determined by a default judgment." (citing RESTATEMENT (SECOND) OF JUDGMENTS § 58 (1982))); Lamden, *supra* note 26, § 17.07[2] ("If

Under the ALI approach, insurers have several bases for challenging disputed settlements. If the settlement is collusive or fraudulent, the insurer is relieved from responsibility.[38] If the settlement, although not collusive, is unreasonably high in amount, the insurer is relieved from any obligation to pay the unreasonably large portion of the settlement, but remains responsible for the portion that is reasonable.[39] Insurers may challenge this approach and argue that an unreasonable settlement should be completely unenforceable, but this argument appears to have received little support in the courts.[40] In addition, breach of the duty to defend does not, in the absence of bad faith or a statutory violation, obligate the insurer to pay more than the policy limits.

The ALI approach further allows the insurer to be relieved from paying the unreasonable amount of a policyholder's settlement, but it imposes the burden of proof of unreasonableness upon the insurer.[41] And, to perhaps point out the obvious, where the insurer's refusal to defend was correct and there was no potential for coverage presented by the claim against the policyholder, the insurer owes no defense payment and no coverage for any resulting judgment or settlement.[42]

A particular point of contention for insurers viewing the draft of *Restatement* section 21 (then-*Principles* section 21) to be presented at the 2014 ALI Annual Meeting was the hourly rate paid used to determine compensation of defense counsel or reimbursement of defense costs.[43] Typically, rates paid to insurer-selected panel counsel are significantly lower than those paid to the outside counsel usually retained by businesses. Insurers contend that they should not be required to pay Wall Street rates for independent counsel or in reimbursement to policyholder counsel used when the insurer has failed to provide a defense.[44] This is a fair point in that insurers have largely succeeded in negotiating lower rates than those paid by policyholders for counsel competent to defend most claims due to the insurer's ability to provide a high volume of repeat business in return. The ALI responded by revising this section of the document before submitting for final approval.[45] But the problem of counsel fees is a comparatively minor one, hardly something to prevent implementation of an otherwise good idea. For more than twenty-five years, California has, apparently effectively, addressed this problem by statute, at

an insurer breaches its duty to defend, however, the insured may enter into a reasonable, non-collusive settlement without the consent of the insure[r] and without forfeiting coverage.").

38. *See* PRINCIPLES, *supra* note 32, § 28 reporters' note e.

39. *See id.* § 21 cmt. d.

40. *See id.* § 28 reporters' note e.

41. *See id.* at cmt. d.

42. *See* Hall, *supra* note 23, § 11A.29.

43. *See* Maniloff, *supra* note 28.

44. *See id.*

45. *See* ALI PROCEEDINGS 2014, *supra* note 11, at 201 (comments of Reporter Professor Tom Baker) (agreeing to revise *Restatement* provisions regarding ultimate determination of fees paid to defense counsel, backing away from pre-Meeting position that insurers must advance fees based on rates of policyholders' chosen counsel and then sue for refund based on lower rates generally paid to insurer-selected counsel); *see also supra* text accompanying note 21.

least for independent counsel, providing that the compensation for which the insurer is responsible shall be determined according to panel counsel rates for similar work.[46]

Although a well-established principle of contract law holds that the victim of breach should attempt to mitigate its damages, insureds, facing an insurer's breach of the duty to defend, are not ordinarily required to hire counsel at their own expense to step into the breach and defend the lawsuit against the insured defendant.[47] "Most courts . . . have rejected this viewpoint and have held that when the insurer refuses to defend, the insurer assumes the risk that the insured will hire no attorney at all and allow a default judgment to be entered."[48] However, it can be argued that the full amount of a judgment against the insured, even a default judgment, is a foreseeable consequential damage of the insurer's breach of its defense obligation. But courts rejecting this approach expressly or implicitly view the "punishment" of uncapping the policy limits (as well as barring coverage defenses) as too severe for the "crime" of failing to defend, at least where there is no insurer bad faith.[49]

Although issues of retention and compensation of counsel by the policyholder present some difficulty, what makes ALI *Principles* section 21 most controversial is that it also provides that after breaching the duty to defend, the insurer loses the right to contest coverage—even if the breach of the duty to defend was not in bad faith.

V. NEW YORK'S RECENT ABOUT-FACE ON THE ISSUE

In addition to the attention focused on the issue by the *Restatement*, the New York Court of Appeals addressed the matter, taking divergent views *in the same case*.[50] Initially holding that breach of the defense duty estopped the insurer from contesting coverage,[51] the court subsequently reversed itself in 2014.[52] The reversal was based on its belated focus on precedent to which a majority of the court felt bound,[53] but was not prompted by any reassessment of the arguments in favor of barring the erroneously nondefending insurer from contesting coverage.

In *K2 Investment Group, LLC v. American Guarantee & Liability Ins. Co.* (*K2-I*)[54] the court, in essence, took the ALI approach and ruled that a liability insurer in

46. *See* CAL. CIV. CODE § 2860(c) (Deering 2014). This statute provides that where there is a conflict of interest between insurer and policyholder, the policyholder is entitled to select its own defense counsel and that the insurer's payment obligation will generally be limited to the customary rate charged by insurer panel counsel for similar cases.

47. *See* JERRY & RICHMOND, *supra* note 1, § 111, at 862.

48. *Id.*

49. *Id.* at 856.

50. *Compare* K2 Inv. Grp. LLC v. Am. Guarantee & Liab. Ins. Co. (*K2-II*), 6 N.E.3d 1117 (N.Y. 2014), *with* K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co. (*K2-I*), 993 N.E.2d 1249 (N.Y. 2013).

51. *K2-I*, 993 N.E.2d at 1253–54.

52. *K2-II*, 6 N.E.3d at 1120.

53. Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford, 477 N.E.2d 441 (N.Y. 1985).

54. *K2-I*, 993 N.E.2d at 1249.

breach of the duty to defend was prohibited from litigating coverage defenses. In holding that breach of the duty to defend strips the insurer of the right to contest coverage, the 2013 *K2-I* decision justified the decision on analytic and public policy grounds very much in line with the ALI analysis:

> This rule will give insurers an incentive to defend the cases they are bound by law to defend, and thus to give insureds the full benefit of their bargain. It would be unfair to insureds, and would promote unnecessary and wasteful litigation, if an insurer, having wrongfully abandoned its insured's defense, could then require the insured to litigate the effect of policy exclusions on the duty to indemnify.[55]

But in 2014, in *K2 Investment Group, LLC v. American Guarantee & Liability Ins. Co. (K2-II)*,[56] the court reversed itself and held that an insurer in breach of the duty to defend retained the right to dispute coverage. The unusual about-face occurred in response to a request for rehearing that noted that *K2-I* had not dealt with *Servidone Construction Corp. v. Security Ins. Co. of Hartford*,[57] which answered "no" to the following question:

> Where an insurer breaches a contractual duty to defend its insured in a personal injury action, and the insured thereafter concludes a reasonable settlement with the injured party, is the insurer liable to indemnify the insured even if coverage is disputed?[58]

Focused on *Servidone*, the *K2-II* Court in a 4–2 vote overturned the unanimous *K2-I* decision of a year earlier.[59] Almost overnight (by judicial timelines), the Court of Appeals went from a 6–0 decision in favor of requiring insurers in breach to forfeit coverage defenses to a 4–2 decision holding that breach of the duty to defend, although giving rise to some forms of incidental and consequential damage, does not strip the insurer of the right to contest coverage.[60]

The New York episode presents a missed opportunity in which an important jurisdiction could have moved this area of law in a more productive direction consistent with the vast role of liability insurance in modern society. In the absence of binding precedent, however, it appears that the Court supports the ALI approach analytically, although the *Restatement* draft was not cited in *K2-I*.

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55. *Id.* at 1254.
56. *K2-II*, 6 N.E.3d at 1117.
57. *Servidone Constr. Corp.*, 477 N.E.2d at 441.
58. *Id.* at 442.
59. *K2-II*, 6 N.E.3d at 1124.
60. *Id.*

VI. THE COMPETING ARGUMENTS REGARDING FORFEITURE OF COVERAGE DEFENSES AS A SANCTION FOR BREACH OF THE DUTY TO DEFEND

A. The ALI's Rationale

Regardless of the state-by-state scorecard, of course, the ALI position and the insurer opposition to it need to be judged on their respective merits. Proponents of the ALI approach argue that loss of coverage defenses is the "better rule" because it

> properly aligns the defense incentives of the insurer and the insured in situations in which the insurer's potential coverage defense otherwise would reduce the incentive to defend the claim. In a full-coverage case, the insurer faces all of the legal risks posed by the claim and has the appropriate incentive to fulfill the duty to defend in a manner that reflects all of those legal risks. When the insurer has a potential coverage defense, however, the insurer may not face all of the legal risks posed by the claim and, therefore, does not have the same incentive to fulfill the duty to defend despite being legally obligated to do so . . . . [T]he forfeiture-of-coverage-defense rule is analogous to the duty to make reasonable settlement decisions, which encourages an insurer to evaluate a settlement as if the insurer would be obligated to pay the full amount of any judgment . . . .
>
> . . . .
>
> An insurer that could refuse to defend but still preserve its coverage defenses would be much less willing to provide the promised defense . . . . The forfeiture-of-coverage-defense rule is one of the insurance-law rules that firmly underscore the principle that the promise to defend is a promise to perform, not simply a promise to decide whether to perform or to pay ordinary contract damages. [It] discourages insurers from attempting to convert a duty-to-defend policy into an after-the-fact defense-cost-reimbursement policy.[61]

Two prominent commentators appear to support the ALI position in large part:

> At first glance, it might seem that estopping the insurer to deny coverage when it unjustifiably refuses to defend puts the insurer in an impossible dilemma. . . . The answer is that the insurer is not on the horns of a dilemma because . . . . [t]here are mechanisms that enable an insurer to perform its duty to defend without giving up the right to contest coverage later[, such as defense under reservation and pursuit of declaratory judgment]. . . .
>
> . . . .
>
> Indeed it is the availability of these procedural alternatives that provides the best reason for estopping the insurer to deny coverage when it breaches the duty to defend.[62]

61. *See* PRINCIPLES, *supra* note 32, § 21 cmt c.

62. JERRY & RICHMOND, *supra* note 1, §111, at 860 (citations omitted); *accord* PRINCIPLES, *supra*

Proponents of the view that an erroneous failure to defend, even if not in bad faith, precludes the insurer from later raising coverage defenses also note that this is consistent with the rule that defending insurers who fail to reserve their rights to contest coverage (usually in the form of the well-known "reservation of rights" letter) may not raise coverage defenses.[63] An insurer who erroneously fails to provide any defense at all should not have greater rights to contest coverage.

B. Insurer Arguments Against the ALI Proposal

Insurers and some commentators have disagreed with the ALI analysis, arguing that forfeiture of coverage defenses for breach of the duty to defend is an excessively harsh remedy that is not sufficiently connected to the breaching conduct and that it improperly expands the scope of insurance coverage purchased even though the breach related to a different aspect of the policy.[64] Further, insurers argue that if the insurer in breach of the duty to defend is estopped from being able to present its coverage defenses, this can easily be an "estoppel into coverage" by requiring the insurer, because of its conduct in failing to defend, to provide coverage beyond the scope of the policy and the insuring agreement between the parties.[65]

Insurers also argue that if the insurer is required to pay the full amount of a judgment against the insured, including the portion exceeding policy limits, this results in a judicially imposed penalty akin to punitive damages. But, continue insurers, punitive damages are not available for a "mere" breach of contract absent bad faith or another independent tort accompanying the breach.[66] Put another way, the insurer argument is that the size of any judgment against the insured is based on the harm inflicted by the insured upon a plaintiff, regardless of whether the harm is covered under the insurance policy. In such situations, insurers argue, even an insurer in breach of the duty to defend should not be prevented from presenting its

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note 32, § 21 cmt c. The ALI Principles project also takes the view that an insurer's failure to provide independent counsel in cases of insurer-insured conflict. *See* MANILOFF & STEMPEL, *supra* note 5, ch. 6, constitutes a breach of the duty to defend that results in forfeiture of coverage defenses; PRINCIPLES, *supra* note 32, § 21, reporters' note a (citing Great Divide Ins. Co. v. Carpenter *ex rel.* Reed, 79 P.3d 599, 609–10 (Alaska 2003)). An insurer may breach the duty to defend not only through an outright refusal to defend but also by provision of an inadequate defense. *See* PRINCIPLES, *supra* note 32, § 21, reporters' note a (citing Sierra Pacific Indus. v. Am. States Ins. Co., No. 2:11-cv-00346-MCE-JFM, 2011 WL 2935878, at *6 (E.D. Cal. July 18, 2011) and Carrousel Concessions, Inc. v. Fla. Ins. Guar. Ass'n, 483 So. 2d 513, 517 (Fla. Ct. App. 1986)).

63. *See, e.g.*, Safeco Ins. Co. v. Ellinghouse, 725 P.2d 217, 220–21 (Mont. 1986); Transamerica Ins. Grp. v. Chubb & Son, Inc., 554 P.2d 1080, 1082–83 (Wash. Ct. App. 1976).

64. *See* Maniloff, *supra* note 28 ("Waiver of coverage defenses is a very strong—punitive you might say—consequence for a breach of the duty to defend."); BARKER, *supra* note 26, § 6.08[2] (criticizing loss of coverage defenses as too severe a sanction for insurers breaching duty to defend); WINDT, *supra* note 26, § 4:37 ("[A]n insurer's unjustified refusal to defend does not estop it from later denying coverage under its duty to indemnify . . . . The insurer's breach of contract should not, however, be used as a method of obtaining coverage for the insured that the insured did not purchase.").

65. *See* JERRY & RICHMOND, *supra* note 1, § 111, at 860.

66. *Id.*

case that part or all of a judgment against the insured fell outside the scope of coverage.[67]

In addition, insurers argue that even without the loss of coverage defenses, they are subject to a number of remedies available to the insured where there has been a breach of the duty to defend, which are listed below:[68]

> · The insured's ability to allow judgment by default to the plaintiff, with the insurer bound by the judgment (at least up to policy limits) so long as there is coverage.
>
> · The insured's ability to settle the claim in return for assignment of its rights under the policy and a covenant not to sue, with the insurer being bound to the amount of settlement so long as it is reasonable and not collusive or fraudulent.
>
> · "Even if the insured cannot or does not obtain a covenant not to sue [when settling a claim], the insurer will be liable for any covered judgment and for any noncovered portion of a judgment that could have been avoided by proper defense and could not have been avoided by reasonable steps the insured could have taken to mitigate damages."[69]
>
> · If the insured incurred any defense costs, they are recoverable.
>
> · The result of the ALI approach, which frees the insured of the need to worry about proving entitlement to coverage, "is almost sure to be an inflated judgment, unless liability were clear and the damages clearly in excess of limits."[70]
>
> · If the insurer's breach of the defense duty is in bad faith, the policyholder is entitled to exceptionally good remedies, including tort damages and perhaps even punitive damages.[71]

C. "Estoppel" as a Basis for Barring Coverage Defenses by an Insurer in Breach of the Duty to Defend

Another argument against the ALI approach is that an insurer's breach of the duty to defend does not actually support a finding of equitable estoppel against the insurer. Critics of "estopping" the defense-breaching insurer from litigating coverage argue that, pursuant to equitable estoppel doctrine, there must be some misstatement or conduct of the insurer that misleads the policyholder and upon

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67. *See id.*; *see also* BARKER, *supra* note 26, § 6.08[2] (noting widespread judicial approach of holding insurer breaching in bad faith responsible for entire judgment or settlement); *id.* § 6.08[3] (If Breach Was in Bad Faith, Insurer Can Suffer Expanded Liability).

68. This listing is derived from WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION § 3.08 (2d ed. 2014) (Consequences of Breach of Duty to Defend).

69. *Id.*

70. *Id.*

71. *See* WINDT, *supra* note 26, § 4:37 (setting forth similar arguments against loss of coverage defenses for insurers in breach of duty to defend); *see also* MANILOFF & STEMPEL, *supra* note 5, ch. 21 (First and Third-Party Bad Faith Standards) (noting that in many states, an insurer may avoid bad faith liability so long as its position regarding a matter is "fairly debatable," even if well short of convincing).

which the policyholder relies to its detriment.[72] Although this analysis may be technically correct as a matter of equitable estoppel doctrine, proponents of the ALI approach might correctly respond that it misses the point in that the ALI approach is premised on a public policy and incentives analysis rather than a strict application of equitable estoppel doctrine.

Unfortunately, in barring insurers in breach of the duty to defend from raising coverage defenses, courts have used the term estoppel loosely and even erroneously.[73] Decisions frequently state that the breach "estops" the insurer from contesting coverage but are unclear as to what type of estoppel is envisioned.[74] Similarly, courts refusing to bar the insurer in breach from contesting coverage frequently state that the insurer "is not estopped,"[75] which arguably perpetuates a

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72. *See, e.g.*, BARKER, *supra* note 26, § 6.08[3]; WINDT, *supra* note 26, § 4:37, at 4-301 to -303. *See generally* FARNSWORTH, *supra* note 23, §§ 4.16, 6.12. This is contrasted with promissory estoppel in which the wrongdoer is not precluded from exercising contract rights due to misstatements or misconduct, but where statements reasonably induce reliance so as to make it unjust not consider a contract to have been made. *See* RESTATEMENT OF CONTRACTS § 90 (1981); FARNSWORTH, *supra* note 23, § 4.15.

73. As discussed below, courts frequently use the term "estoppel" in these cases but are not clear as to whether they mean equitable estoppel, promissory estoppel, collateral estoppel, or what might be termed "contract estoppel"—the concept that a sufficiently egregious material breach of contract requires that the breaching party be deprived of certain contract rights it would otherwise have. A more common remedy for material breach is to permit the victim to elect either to end the contract or sue for damages. However, walking away from an insurance contract is not a reasonable remedy for the policyholder because the policyholder is unable to procure substitute insurance after a loss has occurred. Regarding the inefficacy of voidability as a remedy for material breach of an insurance policy, see *infra* text accompanying note 90. Regarding vague use of term "estoppel" by courts, see *supra* and *infra* note 74.

74. *See, e.g.*, Federal Ins. Co. v. Stroh Brewery, 35 F. Supp. 2d 650, 654–57 (N.D. Ind. 1998) (court on remand addresses estoppel issues decided adversely to insurer by Seventh Circuit but is not clear as to precise type of estoppel at issue); Progressive Cas. Ins. Co. v. Skin, 211 P.3d 1093, 1103 n.38 (Alaska 2009) (where insurer breaches duty to defend "coverage by estoppel" is the "usual remedy," but "does not apply where an insurer has violated only its duty of disclosure with regard to a coverage defense that is unrelated to the coverage defense that forms the basis for the insurer's ultimate denial of coverage") (court not clear as to whether it is referring to equitable estoppel or different variety of estoppel); Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust, 708 N.E.2d 1122, 1135 (Ill. 1999) ("Once the insurer breaches its duty to defend . . . the estoppel doctrine has broad application and operates to bar the insurer from raising policy defenses to coverage, even those defenses that may have been successful had the insurer not breached its duty to defend.") (court unclear); Scentry Biologicals, Inc. v. Mid-Continent Cas. Co., 319 P.3d 1260, 1267 (Mont. 2014) (breaching insurer estopped from denying indemnification for insured's damages, including settlement amount and attorney fees) (court unclear as to type of estoppel).

Ehlco Liquidating Trust is perhaps the leading case reflecting the minority rule of insurer loss of coverage defenses as a consequence of breach of the duty to defend. Although the court did not use the term "contract estoppel" per se, one can reasonably read the case as applying this concept. *See Ehlco*, 708 N.E.2d at 1135 (estoppel employed by court "arose out of the recognition that an insurer's duty to defend under a liability insurance policy is so fundamental an obligation that a breach of that duty constitutes a repudiation of the contract.") Alternatively, the court's reasoning can be seen as akin to the argument made below, see *infra* text accompanying notes 90–92, that a proper adaptation of the material breach concept in contract law supports the ALI position. But rightly decided as *Ehlco Liquidating Trust* may be, the court uses the term "estoppel" in an unclear manner.

75. *See, e.g.*, EMC Ins. Cos. v. Mid-Continent Cas. Co., 884 F. Supp. 2d 1147, 1173 (D. Colo.

straw man argument in that, as discussed below, the rationale for requiring the breaching insurer to forfeit coverage defenses, although perhaps a form of "contract" estoppel, does not depend on the applicability of either equitable estoppel or collateral estoppel.

The use of the term "estopped" to describe the mechanism by which the insurer in breach is prevented from contesting coverage is unfortunate. Many courts opposed to stripping the insurer of coverage defenses have incorrectly seized upon this term as implying that for the insurer in breach to lose coverage defenses or even to be bound by judgment in the underlying case,[76] the elements of collateral estoppel (or issue preclusion, which requires actual litigation of issues necessary to a judicial decision) or equitable estoppel (which requires conduct or a statement inducing reasonable detrimental reliance) must be satisfied.

This is incorrect. Where the nondefending insurer loses the right to contest coverage as a consequence of the breach, it is because (in the states so providing) loss of coverage defenses is a logical and fair consequence of the breach on both doctrinal and policy grounds. It is not because the insurer is "estopped" in the technical sense required for collateral estoppel (which requires a prior adjudication of facts) or equitable estoppel (which requires reliance on conduct or statements of the party to be estopped). Rather, the term "estoppel" or "estopped" as used in so many cases barring the breaching insurer contesting coverage means merely that the insurer who breaches the duty to defend is thereafter held to the outcome of the case below and unable to debate coverage after wrongly leaving the policyholder exposed to a lawsuit that should have been defended.

In the law, the term "estoppel" has a host of meanings, including collateral estoppel (claim preclusion),[77] promissory estoppel (the creation of a contract by promise and reasonable reliance), judicial estoppel (inability to argue inconsistent

2012) (rejecting EMC's "apparently, quasi-estoppel" argument because an insurer's actions under "implied waiver and estoppel" cannot create coverage under a policy risk that does not otherwise exist); Hinkle v. Crum & Forster Holding, Inc., 746 F. Supp. 2d 1047, 1054 (D. Alaska 2010) (concluding doctrine of coverage by estoppel inapplicable; noting estoppel generally reserved for circumstances of insurer misconduct); Ala. Hosp. Ass'n Trust v. Mut. Assurance Soc'y of Ala., 538 So. 2d 1209, 1216 (Ala. 1989) ("A failure of an insurer to defend a claim against an insured does not work an estoppel on the issue of coverage."); Hirst v. St. Paul Fire & Marine Ins. Co., 683 P.2d 440, 447 (Idaho Ct. App. 1984) ("We question the propriety of utilizing a form of estoppel as a punitive measure against an insurer for breach of a contractual duty to defend. Rather, we believe the sanction for that breach should be governed by ordinary principles of contract law.").

76. *See* cases cited *supra* note 75.

77. Collateral estoppel is a civil procedure concept more properly referred to as "issue preclusion." It is imposed to bar relitigation of an issue that was actually litigated in a prior suit by the party (or a sufficiently affiliated party) when the issue was actually litigated and decided (not merely adverted to) in the prior suit and where the decision on this issue was necessary to the resolution of the prior lawsuit. *See* Taylor v. Sturgell, 553 U.S. 880, 885 (2008) (setting forth elements of issue preclusion and circumstances it may be imposed even when party seeking to litigate in second case was not party in prior case); JEFFREY W. STEMPEL ET AL., LEARNING CIVIL PROCEDURE 860–61 (2013) (listing and explaining elements).

positions before courts)[78] (and an arguable cousin in the "mend the hold" doctrine that, in spite of alternative pleading, prevents litigants from switching to a position directly opposite one previously advanced in the case),[79] equitable estoppel (requiring misconduct and detrimental reliance), and contract estoppel.[80] In addition, waiver and equitable estoppel are often conflated.[81] If the term "estoppel" is to be applied to this area, it is this last form of estoppel—contract estoppel—(if persuasive to courts) that supports stripping nondefending insurers of coverage defenses as well as a broader, common sense notion of fairness that precludes a party from taking action inconsistent with past conduct or that strips an actor of certain rights because their conduct makes invocation of those rights unfair in light of their past conduct. As one commentator observed,

> [t]he contractual estoppel doctrine should not be confused with the related but distinct doctrine of equitable estoppel. . . . [E]quitable estoppel requires a showing of prejudice; contractual estoppel does not. Although the contractual estoppel and equitable estoppel doctrines share common roots (and courts often confuse them), they are wholly independent and distinct legal theories.[82]

Appreciating that the dispute over stripping the insurer of coverage defenses is not one of equitable estoppel avoids misdirection and allows the issue to be

78. The doctrine of judicial estoppel "generally prevents a party from prevailing in one phase of a case on an argument and then relying on a contradictory argument to prevail in another phase." Pegram v. Herdrich, 530 U.S. 211, 227 n.8 (2000); *see also* Davis v. Wakelee, 156 U.S. 680, 689 (1895) ("[W]here a party assumes a certain position in a legal proceeding, and succeeds in maintaining that position, he may not thereafter, simply because his interests have changed, assume a contrary position, especially if it be to the prejudice of the party who has acquiesced in the position formerly taken by him."). The purpose of judicial estoppel is to preserve the integrity of the judicial process and prevent the perversion thereof. *See, e.g.*, New Hampshire v. Maine, 532 U.S. 742, 750 (2001).

79. *See* Harbor Ins. Co. v. Cont'l Bank Corp., 922 F.2d 357, 362–64 (7th Cir. 1990) (describing the "mend the hold" doctrine found in Illinois and other states, which provides that notwithstanding that litigation permits pleading in the alternative, a party to a contract dispute cannot adopt a particular position and then later take a completely inconsistent position in the absence of new information). In *Harbor Ins. Co.*, Harbor and Allstate initially (in their declaratory judgment complaint) argued they owed no liability to Continental for injuries arising from the misconduct of their directors because the misconduct had been so "egregious" that indemnity would violate state and federal law. *Id.* at 363. Subsequently, in the same litigation (in defending against a counterclaim), Harbor and Allstate asserted the complete opposite, contending that they owed no liability to Continental because their directors have never been shown to have committed any wrongful acts so as to give rise to liability. *Id.* at 365.

80. See *infra* text accompanying note 81–82, discussing contract estoppel as a concept.

81. As noted above, equitable estoppel applies to bar a party from doing something inconsistent with prior statements or actions when another has relied on those statements or actions to its detriment. Waiver is the voluntary relinquishment of a known right. *See* FARNSWORTH, *supra* note 23, § 8.5. Because waiver can be constructive as well as express, it can sometimes be difficult to distinguish between constructive waiver (based on a party's actions or statements that stop short of express waiver) and equitable estoppel based on such conduct. As a practical matter, the exact categorization is not particularly important. In either event, it would be unfair to let the party in question have the benefit of a contract provision it has forgone or that is inconsistent with its conduct causing injury to another.

82. *See* Hall, *supra* note 23, § 11A.32 (citing Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust, 708 N.E.2d 1122, 1133–35 (Ill. 1999), a leading case consistent with the ALI approach).

assessed as it should be—upon whether the remedy is apt or excessive in light of the nature and magnitude of the breach and the operation of liability insurance.

Similarly, courts err if they apply the doctrine of claim preclusion (res judicata) or issue preclusion (collateral estoppel) in these situations or the frequent situation of an undefended policyholder settling the claim against it. Regarding the conclusiveness of a policyholder's settlement, an "estoppel" analysis focusing on issue preclusion is an unproductive detour. The real question is whether the insurer—having forfeited the right to control defense and settlement—should be permitted to second-guess the settlement in which it declined to be involved. Asking whether civil procedure preclusions apply to a nondefending insurer is the wrong question. The better question is whether barring an insurer's coverage defense is an apt sanction and remedy for the insurer's breach of the duty to defend.

Although not a particularly good analogy, but one better than equitable estoppel, the concept of barring a nondefending insurer's coverage defense is more akin to judicial estoppel, which although technically having an element of reliance to it, essentially provides that a lawyer or litigant cannot say *X* in one court and then be heard to say non-*X* in another court.[83] Similar as well is the "mend the hold" doctrine that does not permit a litigant to assert a particular defense (e.g., that the matter is not covered because of the policyholder's intentional misconduct and intent to injure) and then later shift to a completely contradictory defense (e.g., that a settlement was unreasonable because there was no credible evidence of any injury inflicted by the policyholder).[84]

More aptly, the notion of precluding a breaching insurer from contesting coverage can be analogized to the common usage of "estoppel" to describe the situation in which an actor's prior conduct prevents an actor who has expressed a view in time *A* from being taken seriously when expressing a contrary view in time *B*. Think of politicians, political pundits, or sports prognosticators (e.g., the columnist perennially predicting "the Cubs will win the pennant" may not be syndicated by many newspapers thereafter, except for comic relief).[85]

83. *See supra* text accompanying note 78.

84. *See supra* text accompanying note 79; *see, e.g.*, *Harbor Ins. Co.*, 922 F.2d at 362–64 (applying Illinois law) (discussing "mend the hold" doctrine and policy against permitting litigant to consecutively assert irreconcilably inconsistent positions).

85. In common parlance, public actors are often described as being "estopped" to make a claim not only when it is inconsistent with their prior conduct, but also where it seems unfair under the circumstances to permit the actor to take the second position. *See, e.g.*, John M. Bickers, *The Power to Do What Manifestly Must Be Done: Congress, the Freedmen's Bureau, and Constitutional Imagination*, 12 ROGER WILLIAMS. U. L. REV. 70, 111 (2006) (noting that Civil War era Democratic Representative Shanklin argued that Republicans had "'dragged' the slavery question into the war, and were therefore estopped from arguing any expansion of federal power be based upon it"); Robert Hockett, *The Limits of Their World*, 90 MINN. L. REV. 1720, 1784 (2006) (reviewing JACK L. GOLDSMITH & ERIC A. POSNER, THE LIMITS OF INTERNATIONAL LAW (2005)) (referring to nations that enter into treaties with undemocratic regimes as being "estopped from laying claims against those regimes' democratic successors"); Ruth Wedgewood, *The Revolutionary Martyrdom of Jonathan Robbins*, 100 YALE L.J. 229, 315 (1990) ("The reprinting of John Adams' *Defence of the Constitutions of Government of the United States of*

Rather than talk in terms of estoppel, even "contract estoppel," which is the most apt version of estoppel in such situations,[86] it could perhaps be more productive to assess the consequences of breach of the duty to defend on other doctrinal grounds such as laches, material breach, and even unconscionability as well as upon grounds of public policy. Using estoppel-talk (other than perhaps the term contract estoppel) arguably only confuses the situation, although most people know what one means when saying that Actor *X* is estopped from arguing *Y* because of his prior misconduct.

A laches analysis also makes some sense in that the insurer that erroneously refused to defend has bypassed an opportunity to assert its rights (to defend under reservation and/or seek declaratory judgment).[87] Having bypassed that opportunity, it then becomes too late for the insurer to argue coverage issues. The insurer, had it defended, could have both protected the policyholder and clarified factual issues pertinent to determining coverage (perhaps by paying for independent counsel if there was a conflict between insurer and policyholder).[88]

Further, it might be more analytically satisfying to hold that it is unreasonably favorable for an insurer in breach of the duty to defend to be permitted to litigate coverage defenses after the insurer's conduct has put the policyholder in a vulnerable position. Left undefended, the policyholder must either fund its own defense or lose by default and then fight a second (or third or fourth) battle against the insurer over coverage issues.

The situation posed by the nondefending insurer who nonetheless insists on having the same rights to contest coverage, as would a defending insurer, has aspects of substantive unconscionability in that it is an unreasonably favorable state of affairs for the insurer, and procedural unconscionability in that it imposes on the policyholder an unfairly surprising situation.[89] The policyholder paid premiums

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America by Federalist publisher William Cobbett in 1797 may have seemed a deliberate tack to estop the President with his own unguarded words.").

86. In addition, the term and concept of "contract estoppel," although one that makes sense and is recognized by lawyers as the notion that certain actions by a contracting party should logically bar it from the full benefits of the contract, is seldom used in scholarly literature and appears rarely used at all in judicial opinions. *But see* Trowbridge v. Prudential Ins. Co. of Am., 322 F. Supp. 190, 193 (S.D.N.Y. 1971) (characterizing legal position of plaintiff alleged beneficiary of life insurance policy that had been erroneously changed by insurer without proper protocol as a claim based "on a theory of negligent misrepresentation and/or contract estoppel grounded in acts committed by Prudential in 1968. These are independent causes of action, not adverse to one another, which rely on separate and distinct elements."). Unfortunately, the court does not elaborate on its concept of contract estoppel and the elements of such a claim or argument.

87. Laches is the legal concept that bars a party from asserting rights in litigation when it has failed prior to the litigation to act in a timely fashion regarding those rights. *See generally* DAN B. DOBBS, LAW OF REMEDIES: DAMAGES—EQUITY—RESTITUTION 75–105 (2d ed. 1993).

88. Where there are issues presented in a claim against a policyholder that may be determinative of coverage and the resolution of the factual issue is dependent on the litigation, most states find this a sufficient conflict of interest between insurer and policyholder to require that the policyholder be permitted to select counsel rather than being defended by the insurer's panel counsel. *See* MANILOFF & STEMPEL, *supra* note 5, ch. 6.

89. Unconscionability is commonly defined as something unreasonably unfair to a contracting

(perhaps for years without making a claim) and reasonably expected to be provided a defense of any lawsuits with a potential for coverage. The insurer failed to live up to this part of the bargain, imposing unfair and unexpected burdens on the policyholder. Under these circumstances, it is just too good a deal for insurers to be permitted to breach the duty to defend and essentially suffer no consequences because the breaching insurer is still permitted to litigate coverage issues.

D. An Additional Classical Contract Doctrine Rationale Favoring the ALI Approach: Adapting the Material Breach Doctrine to the Breach of the Duty to Defend

More conventionally, the *Restatement* position has an arguable grounding in the adaptation of traditional contract law, particularly in the law of breach and damages. Pursuant to longstanding contract law, the victim of material breach of a contract may lawfully repudiate the contract (as well as collect damages suffered prior to repudiation), while victims of minor breach can collect damages due to the breach but may not walk away from the contract.[90] These victims of minor breach must still perform their contractual obligations.[91]

The traditional doctrinal approach makes perfect sense for typical commercial contracts. If a long-term supply contract vendor is a week late with one delivery, it makes sense to permit the victim to recover damages for the delay, but not to permit the victim to terminate the long-term arrangement over one late delivery (even an important one). But if a one-time vendor delivers a load of inoperable widgets, it makes sense to let the buyer end the contract and seek an alternative vendor rather than engaging in the difficult fact finding and inconvenience (particularly to the buyer) of determining the value of the difference between conforming widgets and inoperable widgets.

But for insurance policies, this traditional approach is meaningless unless adapted to the insurance context. Breach of the duty to defend is a material and substantial breach of a liability insurance policy containing a duty to defend. Liability insurance is often called "litigation insurance" for a reason: a major aspect of its value, perhaps the primary aspect of its value, is that it protects the policyholder from the costs and rigors of litigation management by essentially offloading this responsibility to the liability insurer. It is no accident that liability insurance policies without a duty to defend are usually much cheaper than those with a duty to defend,

party both as a matter substance and where the term is a product of some procedural defect in the bargaining. Normally, there must be elements of both procedural and substantive unconscionability for a court to refuse to enforce an oppressive term that falls short of being illegal or being barred by public policy. *See* FARNSWORTH, *supra* note 23, § 4.28; *see, e.g.*, Gonski v. Second Judicial Dist. Court of State *ex rel.* Washoe, 245 P.3d 1164, 1169–70 (Nev. 2010) (adopting sliding scale approach to determining unconscionability that requires both procedural and substantive unconscionability, but may deem term unenforceable if sufficiently substantively oppressive even if there are only minor procedural problems with the contract); *see also* U.C.C. § 2-301 (1977) (unconscionable term may not be enforced or may be modified to cure unconscionable aspects).

90. *See* FARNSWORTH, *supra* note 23, §§ 8.15–.16.

91. *See id.*

at least if the duty to defend is in addition to the policy limits available for paying claims. Excess and umbrella insurance pricing is also consistent with this fact, although the lower premiums for these policies also, of course, stem in substantial part from the higher attachment points of these policies.

It follows, therefore, that where an insurer incorrectly fails to defend—even if the refusal is not in bad faith—that the policyholder has suffered a material breach of the contract. But unlike the typical victim of material breach, the policyholder has no realistic option of terminating the contract. By definition there is now a lawsuit (or perhaps many suits) against the policyholder. Terminating the insurance arrangement and asking for a refund of premiums is hardly a realistic option. The policyholder needs insurance to face the lawsuit but cannot (except at perhaps extremely high prices) purchase new insurance.[92]

In order to preserve the principle of providing adequate remedy to the victim of a material breach, some adjustment of the material breach doctrine in insurance cases is required. One defensible adjustment is to hold that the insurer guilty of the material breach of failing to defend must suffer a consequence similar to that suffered by material breachers of other types of contracts. As noted above, material breachers of ordinary contracts suffer the risk of losing the deal entirely. By analogy, one can make a strong argument that insurers materially breaching by failing to defend should lose a major part of their initial deal with policyholders—the right to contest coverage.[93]

VII. THE CLARIFYING IMPACT OF ADDITIONAL PERSPECTIVES ON THE INSURANCE CONTRACT

The traditional arguments for and against a nondefending insurer's right to contest coverage provides for a reasonably spirited debate, albeit one I think resolves in favor of the ALI position even without resort to other modes of analysis. But resolution tilts more strongly in that direction when one adds the additional perspective or realization that the socioeconomic role of liability insurance and the degree to which the insurance policy is both a contract and much more.[94] The ALI approach is powerfully supported on the grounds that it promotes the more

92. Many would even argue that the fortuity requirement of insurance is violated by purchasing insurance after a loss and claim have materialized. That is technically incorrect in that there is still some, perhaps even considerable, uncertainty regarding the outcome of the litigation and its ultimate costs, giving the matter the requisite fortuity. But as a practical matter in the insurance marketplace, a policyholder already facing a lawsuit will either be unable to obtain new insurance or will be required to pay a far higher premium for coverage than she paid to the insurer now refusing to defend.

93. *See* JERRY & RICHMOND, *supra* note 1, § 111, at 861 (insured's right after breach of defense duty to settle without insurer permission and hold carrier responsible up to amount of policy limits and other remedies for breach of duty to defend "all follow from a basic principle of contract law: when one party commits a material breach of its duties under a contract, the aggrieved party's obligations to the breaching party are discharged").

94. *See* Stempel, *supra* note 7; Stempel, *supra* note 6; Stempel, *supra* note 5.

harmonious and efficient operation of commerce, commercial liability, and dispute resolution.

Insurance plays a key role in risk management and commerce, particularly so in the case of general liability, which by definition is sold to businesses wishing to manage their litigation exposure.[95] Part of this management, of course, is the ability to "offload" litigation expenses to the liability insurer when the policyholder is sued.[96] Duty to defend doctrine recognizes this implicitly by adopting the view that the insurer must defend so long as there is even a "potential" for coverage based on the allegations, even if the allegations prove (to use the older but still instructive terminology) "groundless, false or fraudulent" and even if the facts as ultimately determined would take the claim outside the scope of coverage or make an exclusion applicable.[97]

One reason for this generous or broader stand for the duty to defend is to make sure that the policyholder receives the "litigation insurance" it purchased.[98] But another important rationale for this approach is that insurer-conducted defense is generally considered more effective and efficient than permitting policyholders to engage in ad hoc defense efforts.[99] For all but the most sophisticated business,

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95. *See* STEMPEL, *supra* note 20, § 14.01[A] (liability insurance policies were created to help manufacturers and merchants manage risk; the commercial general liability policy (CGL), originally titled the "comprehensive" general liability policy, was an innovation designed to bundle various liability insurance products and provide defense coverage); *see also* ELMER W. SAWYER, COMPREHENSIVE LIABILITY INSURANCE (1943) (important insurance industry executive and driving force behind development of CGL explains its rationale).

96. *See* EMMETT J. VAUGHAN & THERESE M. VAUGHAN, FUNDAMENTALS OF RISK AND INSURANCE 9–10 (8th ed. 1999) (describing insurance generally as a means of dealing with risk by transferring it to the insurer that in return receives a premium payment from the policyholder; this method of dealing with risk is contrasted with avoiding the risk—e.g., refraining from certain operations—or retaining the risk through self-insurance or internalizing the cost of risk). Where the liability policy contains a duty to defend, as is the case with the CGL policy, policyholders purchasing insurance are able to transfer not only the risk of an adverse judgment but also the cost of litigation and avoid the logistical burdens of retaining counsel and defending claims as well as sudden demands requiring cash outlays. *Accord* MARK S. DORFMAN & DAVID A. CATHER, INTRODUCTION TO RISK MANAGEMENT AND INSURANCE 10 (10th ed. 2013) (noting insurance as a means of loss transfer in which the financial consequences of risk are shifted to the insurer, a method that logically includes transfer of litigation-cost risk as well as risk of adverse litigation outcomes); *see also* Victor P. Goldberg, *The Devil Made Me Do It: The Corporate Purchase of Insurance*, 5 REV. L. & ECON. 541 (2009) (even wealthy policyholders who appear able to self-insure find purchase of insurance valuable for managing risk and cash flow).

97. *See* MANILOFF & STEMPEL, *supra* note 5, at 89; STEMPEL, *supra* note 20, § 9.03[A], at 9-80 to -81.

98. *See* Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1, 8 (1999) (court "universally" views insurer's defense obligation as more expansive than indemnity obligation).

99. *See* Charles Silver, *Basic Economics of the Defense of Covered Claims*, *in* DANIEL SCHWARCZ & P. SIEGELMAN, RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE, ch. 14 (forthcoming 2015) (manuscript on file with author) ("Liability insurance arrangements generate wealth by transferring risks from policyholder to insurers, who can bear them more cheaply. One such risk attends the defense of covered claims. The cost of defending claims has considerable potential to vary, and the manner of conducting the defense can affect the amount paid to a claimant. It is therefore important to deploy resources efficiently when defending claims."). *Accord* Charles Silver & Kent Syverud, *The*

the liability insurer will be better at managing the defense and settlement of litigation because of the insurer's expertise regarding claim value and the insurer's market power in obtaining qualified counsel at reasonable rates. This infusion of expertise thus facilitates operation of the tort liability system while also freeing the policyholder (who has paid for the privilege through purchase of liability insurance) to both avoid out-of-pocket defense expenses and the distraction entailed in defending litigation.

These systemic advantages of liability insurance are lost when the duty to defend is breached, regardless of whether the breach is merely erroneous or in bad faith. Consequently, the ALI position and similar state precedents can be defended on the ground that although the rule may seem harsh to insurers, it provides useful additional incentive to err on the side of defending a matter in close cases, and therefore maximizes the effectiveness of liability insurance as part of the risk management system. If a case is one that clearly presents no potential for coverage based on the face of the complaint, the insurer can refuse to defend and will suffer no adverse consequences at all.[100] If a case clearly raises a potential for coverage, the duty to defend is triggered. Then, the insurer must defend and, in any event, will "want" to defend to avoid a finding of bad faith and to attempt to minimize plaintiff's recovery against the policyholder. If there are grounds for contesting indemnity coverage, the insurer defends under reservation and preserves its right to contest indemnity coverage.

Thus, whether to follow the ALI approach or the existing majority rule becomes an issue only in close cases, where there may be reasonable debate about whether a defense duty is owed and where the insurer's reasonable (i.e., not in bad faith) objection to defending is rejected by the courts. An approach that encourages insurers to defend in these doubtful cases, litigating the issue in a declaratory judgment, is therefore most consistent with the socioeconomic function of liability insurance. Particularly in states that permit the defending insurer to recoup defense expenditures on a claim that was outside potential coverage,[101] the insurer "nudged" into defending the close case because of the ALI approach would be able to obtain some repayment of defense costs if it prevailed on its arguments against the duty to defend. Seen as part of a systemic whole, the ALI approach has a rationale many find persuasive.

CONCLUSION

The ALI proposal—and the concept—that liability insurers breaching their duties of defending policyholders should be barred from later contesting coverage

Professional Responsibilities of Insurance Defense Lawyers, 45 DUKE L.J. 255, 265 (1995) (insurers and selected defense counsel develop expertise, efficiency, and economies of scale in defending claims).

100. And also, in most states, other information brought to the attention of the insurer. *See* MANILOFF & STEMPEL, *supra* note 5, ch. 5.

101. *See id.* ch. 7 (discussing state law regarding insurer rights to obtain reimbursement of counsel fees spent on portions of a lawsuit not raising potentially covered claims).

has much to recommend it. To be sure, the proposal can be criticized as imposing too draconian a penalty on insurers for "mere" breach of the insurance contract (as contrasted with bad faith breach of contract or breach of the insurer's covenant of good faith and fair dealing). But a closer examination reveals that traditional contract law's concern over rectifying material breach supports making insurers suffer substantial consequences for abandoning policyholders in such material fashion.

The ALI approach may not be dictated by standard contract doctrine—but it is hardly inconsistent with contract law. In particular, the importance of providing a victim with adequate remedies for material breach (and failure to defend is certainly material) argues strongly in favor of providing substantial penalties for such breach. Merely forcing the delinquent insurer to belatedly cover attorney fees long after counsel was most needed is hardly much of a sanction for material breach of this magnitude.

Beyond this, an appreciation of the other traits of an insurance policy in addition to its status as a contract underscores the wisdom of the ALI approach. Insurance policies are industry-designed products in the manner of powerful private legislation that serve an important socioeconomic role for both consumers and commercial policyholders as well as those allegedly injured by those dealings. To properly fulfill this role and comport with its other identities, insurance policies must work as planned and provide the benefits promised.

A core benefit of liability insurance—one at least as important as its indemnity function—is provision of a defense of claims raising a potential for coverage based on the allegations against the policyholder.[102] When insurers fail to live up to this commitment—one relatively easy to ascertain in most cases—they should not be permitted to both fail the policyholder in this crucial regard and retain the opportunity to contest coverage.[103]

Although the ALI approach does not yet enjoy majority support in judicial precedent, this is hardly a strong basis for rejecting a good idea, particularly in light of the age of many precedents and the comparatively light and unreflective

102. *See* MANILOFF & STEMPEL, *supra* note 5, at 89 ("If coverage issues were stocks, the duty to defend would be Blue Chip.") (Policyholders rely on being defended from general liability claims which is why "the duty to defend is broader than the duty to indemnify"); STEMPEL, *supra* note 20, § 9.03[A], at 9-80 ("Liability insurance has often been described as 'litigation insurance'" because of centrality of duty to defend in CGL policies.); *id.* at 9-79 to -82 (duty to defend is broader than duty to indemnify because it is based on facts alleged in complaint and "potential" for coverage without policyholder need to prove entitlement to indemnity coverage). In most states, duty to defend is satisfied when a complaint alleges legal liability falling within coverage of the policy, and an insurer may not defeat the duty to defend by reference to extrinsic evidence while the policyholder may present extrinsic evidence to establish the duty to defend in cases where potential for coverage is not clear from the face of the complaint. *Id.* at 91–94.

103. In addition, the contest over whether there is coverage for resulting liability based on the actually adjudicated facts after trial or during the course of declaratory judgment litigation is often based on a disputed factual record that would often (along with the social costs of prolonged and parallel disputing) have been avoided altogether had the insurer upheld its duty to defend, which so often results in settlement.

consideration of the issue in so many of the "majority rule" cases.[104] "Restating" the law (rather than enunciating preferred "principles") restrains to some degree the opportunity for creativity and law reform. But it hardly requires adherence to an approach that creates perverse incentives for insurers to underperform contractual obligations without penalty. More than sixty million Americans have lived in jurisdictions following the ALI approach for as much as fifty years, and insurers in those states (e.g., California, Illinois) continue to thrive.[105]

In addition to the public policy considerations and desire to create favorable incentives expressly set forth in the Reporter's Notes of the *Restatement*, there are other powerful reasons support the approach: the crucial socioeconomic role of insurance, the product-like nature of the insurance policy, and the potential dispute resolution efficiencies resulting when insurers have greater incentive to defend and resolve claims. The time has come for all courts to adopt it.

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104. *See, e.g.*, Premier Homes, Inc. v. Lawyers Title Ins. Corp., 76 F. Supp. 2d 110, 119 (D. Mass. 1999); Arceneaux v. Amstar Corp., 66 So. 3d 438, 451 (La. 2011); Detroit Edison Co. v. Mich. Mut. Ins. Co., 301 N.W.2d 832, 836–37 (Mich. Ct. App. 1980).

105. Ironically, Illinois, the state with the clearest and strongest caselaw favoring the ALI approach, is the home state of two of the world's largest insurers (State Farm and Allstate), both of which have fared well notwithstanding.