

INSURER OR POLICYHOLDER CONTROL OF THE DEFENSE AND THE DUTY TO FUND SETTLEMENTS

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I. INTRODUCTION

Liability insurance coverage disputes often evolve out of the insurer's duty to defend the policyholder from suits within the coverage promised by the insurance contract. When the duty to defend is triggered,¹ the insurer enjoys, and is burdened with, the contractual duty to assume control of the defense of the suit against the policyholder. Control entitles the insurer to select and direct defense counsel. Control entitles the insurer to determine defense strategy, including whether to compromise the claim by settlement or to litigate the claim to judgment. Control by the insurer is so pervasive that for claims that are likely to be resolved within the policy limits of the insurance contract the policyholder is often treated as a mere bystander to resolution of the underlying claim.²

The insurer's defense duties are defined by a body of law that imposes significant obligations on the insurer in control of the policyholder's defense. The insurer's obligations to the policyholder, insofar as control of the defense is concerned, are often characterized by courts as fiduciary in nature.³ The insurer that accepts the tender and enters into the defense of the policyholder is

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¹ The duty to defend attaches when the claim stated against the policyholder is one which if true would be covered by the policy. Jurisdictions vary as to whether this determination is limited to the allegations in the claim or whether the determination may be influenced by external factors. See James Fischer, *Broadening the Insurer's Duty to Defend: How Gray v. Zurich Insurance Co. Transformed Liability Insurance Into Litigation Insurance*, 25 U.C. DAVIS L. REV. 141 (1991); ROBERT JERRY II, UNDERSTANDING INSURANCE LAW § 111 (2d ed. 1996). See *infra* notes 45-54 and accompanying text (discussing scope of duty to defend).

² See, e.g., *Robertson v. Chen*, 52 Cal. Rptr. 2d 264, 267-68 (Ct. App. 1996) (noting that "it is common practice for insurance counsel and an adjuster to handle the negotiation of insurance-funded settlements without the superfluous involvement of a fully-protected insured"). This insurer-control may be facilitated by statute. See, e.g., CAL. BUS. & PROF. CODE § 6103.5 (West 2001) and Cal. Rule of Professional Conduct, Rule 3-510(B) (both requiring lawyer to communicate settlement offers to "clients" and defining clients to include a person employing the lawyer who possesses the authority to accept an offer of settlement).

³ *Birth Center v. St. Paul Cos., Inc.*, 727 A.2d 1144 (Pa. Super. Ct. 1999):

The fiduciary relationship arising out of the insurance contract is based upon the trust and reliance that the insured is required to place in the insurer as a result of the unequal bargain and the insurer's retention of discretionary control over the decision to settle or litigate the claim.

bound to the policyholder. If the claimant is successful and prevails against the policyholder, the insurer, having controlled the defense, may not now contend that the claim is nonmeritorious or that it is not covered by the insurance contract. Having litigated and lost, or settled to avoid a loss or further expense, the insurer now pays the claimant the sum determined, up to the indemnity limits of the policy. I characterize this position as the "standard" relationship. It typifies the great majority of insurer-policyholder relationships involving liability insurance and claim dispute resolution.

There are three recurring situations, however, when a claim falls outside the standard relationship. In the first situation, the insurer may breach its contractual promise to provide a defense thereby forcing the policyholder to assume its own defense. The usual judicial response in the insurer-breach case is to treat the claim as if it were within the "standard" relationship. The insurer is deemed bound by a result reached in its absence to the same extent as when the insurer is present and in control of the defense. This resolution discourages insurer rejection of the policyholder's tender of the defense because the insurer retains the burdens of the defense without the benefits of control. This approach is "fault" driven; it is the insurer's breach of its duty to defend that binds it to a dispute resolution to which it was not a party.

The second situation arises when a conflict of interest exists between the insurer and the policyholder, usually over whether the claim is covered under the insurance contract. The presence of a conflict of interest may deprive the insurer of its right to control the defense, but not its duty to provide a defense. The distinction between "control" and "duty" is drawn because of the concern that the "conflict" may cause the insurer to use its power to control the defense to the prejudice of the policyholder, such as by causing the policyholder to lose the contractual right of indemnification.⁴ In this situation, the insurer may be required to pay for counsel who is selected and directed by the policyholder if the insurer wishes to later contest its duty to provide indemnification for the

Id. at 1157-58. The reference is metaphorical. An insurer is not a fiduciary simply because it, as an insurance company, has entered into a contractual relationship with a policyholder. *Szumigala v. Nationwide Mut. Ins. Co.*, 853 F.2d 274, 280 n.7 (5th Cir. 1988). No court has held that an insurer is a fiduciary in the traditional and formal sense envisioned by Cardozo in *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive. . . ."). Courts that have prescribed a "fiduciary" obligation most commonly refer to the duty as fiduciary in nature. *Hassard, Bonnington, Roger & Huber v. Home Ins. Co.*, 740 F. Supp. 789, 792 (S.D. Cal. 1990) (stating that "the relationship between a policyholder and an insurer has many of the elements of a fiduciary relationship, but is not an actual fiduciary relationship"); *Love v. Fire Ins. Exch.*, 271 Cal. Rptr. 246, 252 (Cal. Ct. App. 1990) (stating that the insurer's obligations "have been characterized as *akin* to fiduciary-type responsibilities"). As Cardozo also noted: "Metaphors in law are to be narrowly watched, for starting out as devices to liberate thought, they often end by enslaving it." *Berkey v. 3d Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926).

⁴ This situation is described in Part IV of this paper. The usual fact pattern involves a claim which, depending on how the facts are resolved, may be a covered claim for which indemnity exists or an excluded claim for which no indemnity exists.

loss.⁵ This resolution of the “conflict” transfers control of the defense from the insurer to the policyholder.

The presence of a conflict of interest between the insurer and the policyholder over coverage does not necessarily excuse the insurer from performing its other defense-related contractual duties, most importantly, its “duty” to settle.⁶ Bifurcation of defense and settlement responsibilities is not, however, problem free. Settlement is closely linked to indemnification. If the insurer must finance a settlement negotiated by the policyholder, the insurer gains little by attempting to preserve a claim that it has no duty to indemnify the policyholder. This is particularly true when the policyholder will be unable to reimburse the insurer for the costs of the settlement if the claims are, in fact, not covered.⁷ In addition, any divestment of the right to control the defense, on which the insurer’s duty to settle is based, is accomplished without the presence of fault, contrary to the situation in the insurer-breach cases. The judicial response to the conflict of interest problem – a conditional defense under a reservation of rights – is supposed to protect *both* the insurer’s right to contest its indemnity obligations and the policyholder’s right to a defense by the insurer.⁸ The problem, however, is that both goals cannot be accomplished simultaneously when the claim settles. The duty to fund the settlement must be allocated to either the insurer or the policyholder. The specific issue of allocation has not been addressed in the conditional defense cases involving a conflict of interest in any rigorous or systematic fashion.

⁵ A policyholder may claim the right to control the defense when the insurer is defending conditionally in cases involving a conflict of interest between the insurer and the policyholder. The jurisdictions split as to the types of “conflicts” that will cause the conditionally defending insurer to lose the right to control the policyholder’s defense. See *infra* notes 90-91 and accompanying text.

⁶ I use the word “duty” with caution because whether a duty to settle exists outside the context of insurer control of the defense constitutes an open issue in most jurisdictions. The standard liability insurance contract does not contractually obligate the insurer to settle; rather, the obligation has been judicially imposed. Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954); Kent Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113 (1990).

⁷ See, e.g., *Mowry v. Badger State Mut. Cas. Co.*, 385 N.W.2d 171 (Wis. 1986):

Badger State could have protected both its interests and its insured’s interests by settling under a reservation of rights agreement, Mowry and the circuit court assert. The record reflects that Badger State’s counsel and its claims manager considered such an option, but ultimately decided to pursue the bifurcation procedure. A reservation of rights agreement would result in a settlement of the [victim’s] claims, while preserving the insurer’s right to litigate the coverage issue. The insured benefits from this procedure because it is protected from excess judgment. Badger State argues, however, that the reservation of rights procedure will rarely result in the insurer’s recouping the payments it made to the victim from the insured where coverage is found not to exist under the policy, because the insured may be judgment-proof.

Id. at 182-83.

⁸ A conditionally defending insurer provides a defense under a reservation of rights or non-waiver agreement that permits the insurer to contest coverage notwithstanding its control of the defense. See *Blue Ridge Ins. Co. v. Stanewich*, 142 F.3d 1145, 1149 (9th Cir. 1998) (noting that an insurer defending conditionally under a reservation of rights is not bound as to coverage by a verdict entered against the policyholder in the underlying action, the defense of which was controlled by the insurer). The conditional defense is discussed in Part IV of this paper, notes 83-111 and accompanying text.

The third situation involves a policyholder who has contractually retained the right to defend itself against claims. The insurer promises to provide solely indemnification for covered losses. This situation, once largely limited to specialized forms of liability insurance coverage, such as Directors and Officers Insurance, is now increasingly being encountered in commercial general liability (CGL) coverages. The representative case involves a large corporate entity that essentially self insures its first layer of coverage through a captive or fronting arrangement and only seeks to insure its extraordinary or catastrophic losses through excess insurance.

This paper explores the question of who should fund a settlement in the differing contexts presented by the standard and non-standard cases. This paper looks specifically at the similarities and dissimilarities between the standard case when the insurer unconditionally assumes the defense on behalf of its policyholder and the non-standard forms in which insurer control of the defense is conditional or non-existent. The position urged in this paper is that in all non-breach situations the funding obligation should be the responsibility of the party in actual control of the defense. The funding obligation is not, however, absolute. A party funding a settlement is entitled to restitution when the other party, be it insurer or policyholder, is determined to be responsible under the insurance contract for the loss covered by the settlement. In this regard, reimbursing a party for settlement funds advanced should be allowed whenever the underlying settlement was reasonable on the merits and non-collusive. The reasonableness of a settlement should be determined without regard to the costs of defense the settlement avoided.

II. THE STANDARD CASE: THE UNCONDITIONAL DEFENSE

In the typical case that initiates an insurer's duties under the standard liability insurance policy, a claim is brought against the policyholder. The policyholder requests a defense by the insurer, *i.e.*, "tenders" the claim to the insurer.⁹

⁹ Many courts treat tender of the claim to the insurer as a condition to the triggering of the duty to defend. See *SCSC Corp. v. Allied Mut. Ins. Co.*, 533 N.W.2d 603, 614 (Minn. 1995), *amended by* 536 N.W.2d 305 (Minn. 1995) (finding that formal tender of defense of claim to the insurer is condition precedent to recover the costs of defense); see also *LaFarge Corp. v. Hartford Cas. Ins. Co.*, 61 F.3d 389, 399-400 (5th Cir. 1995), *overruled in part by* *Federated Mut. Ins. Co. v. Grapevine Excavation, Inc.*, 241 F.3d 396 (5th Cir. 2001); *Eastman v. United States*, 257 F. Supp. 315, 319 (S.D. Ind. 1966); *Celina Mut. Ins. Co. v. Citizens Ins. Co.*, 349 N.W.2d 547, 551 (Mich. Ct. App. 1984). Mere notice of the claim to the insurer absent a tender is generally deemed insufficient to trigger the duty to defend. But see *Cincinnati Cos. v. W. Am. Ins. Co.*, 701 N.E.2d 499, 504 (Ill. 1998) (holding that "the better rule is one which allows actual notice of a claim to trigger the insurer's duty to defend, irrespective of the level of the insured's sophistication, except where the insured has knowingly foregone the insurer's assistance"). The court noted that actual notice of the claim obligated the insurer to at least inquire whether the policyholder wished the insurer to provide a defense. *Id.* at 505. See also *Employers Cas. Co. v. Mireles*, 520 S.W.2d 516 (Tex. Civ. App. 1975) (holding that notice to the insurer was sufficient); *Towne Realty, Inc. v. Zurich Ins. Co.*, 548 N.W.2d 64, 67 (Wis. 1996) (holding that tender occurs once the policyholder gives notice of the claim to the insurer; any uncertainty as to the policyholder's motives must be resolved by the insurer). Constructive tender may also be recognized. See *White Mountain Cable Constr. Co. v. Transamerica Ins. Co.*, 631 A.2d 907, 910 (N.H. 1993) (finding that notice by policyholder to the insurer of the claim constituted an implicit tender

The legal effect of the tender is to confer upon the insurer authority to defend the policyholder.¹⁰ Upon acceptance of the tender, the insurer will conduct an investigation of the claim, usually through its claims facility. The claim may be resolved short of litigation. Many claims are resolved in this way without the involvement of counsel or litigation. In a number of cases, however, the claim cannot be resolved short of litigation. The claimant and the insurer may be too far apart in their estimates of claim value. The claimant may have already initiated litigation by filing and serving a complaint on the policyholder for which a response is due. For these or other reasons the need to involve defense counsel will arise. When that need does arise, it will be the insurer to which the claim was tendered who will make the decision regarding selection of counsel. Through counsel, the insurer will, on behalf of the policyholder, defend the claim. Counsel, retained and directed by the insurer, will determine litigation strategy. For example, should the complaint be answered or challenged by pretrial motion? Who should be deposed? Should the claimant be examined by an Independent Medical Examiner? Should expert witnesses be retained?¹¹ Settlement discussions will be conducted by defense counsel and

when notice was coupled with the policyholder's statement of its belief that the insurer had duty to defend).

¹⁰ The duty to defend is essentially a contractual obligation that is found in standard liability insurance policies. See, e.g., *Stamford Wallpaper Co., Inc. v. TIG Ins. Co.*, 138 F.3d 75, 79 (2d Cir. 1998) (noting that "[t]he nature of the insurer's duty to defend is purely contractual. There is no common law duty as to which courts are free to devise rules.") (quoting *Linemaster Switch Corp. v. Aetna Life & Cas. Corp.*, No. 910396325, 1995 WL 462270, at *5 (Conn. Super. Ct. July 25, 1995)).

It is unclear whether the insurer may defend the claim absent a tender by the policyholder. See *Clemmer v. Hartford Ins. Co.*, 587 P.2d 1098 (Cal. 1978) (holding that the insurer was bound by a default judgment entered against the policyholder because the insurer never sought to have the default judgment set aside); *Nasongkhla v. Gonzalez*, 34 Cal. Rptr. 2d 379, 380-81 (Ct. App. 1994) (permitting liability insurer to intervene to move to set aside default entered against policyholder because otherwise the insurer may have no other opportunity to litigate fault or damages issues if and when claimant seeks to garnish insurance policy proceeds to satisfy default judgment entered against policyholder); cf. *Chapman v. Kamara*, 702 A.2d 977, 987 (Md. Ct. Spec. App. 1997) (noting that customary policy provision requiring the insurer to defend policyholder authorized an initial appearance by retained defense counsel appointed by the insurer to represent the policyholder), *rev'd* 739 A.2d 387 (Md. 1999).

¹¹ How much control the insurer should be allowed over defense counsel's duty to represent the policyholder is a subject that is beyond the scope of this paper. See *In re Rules of Prof'l Conduct & Insurer Imposed Billing Rules & Procedures*, 2 P.3d 806 (Mont. 2000) (holding that insurer imposed requirements on retained defense counsel for policyholders regarding billings and practices interfered with required independent professional judgment that defense counsel, as lawyers, must provide to the policyholders, their clients); cf. *Dynamic Concepts v. Truck Ins. Exch.*, 71 Cal. Rptr. 2d 882, 888 (Ct. App. 1998) (questioning "the wisdom and propriety of so-called 'outside counsel guidelines' by which insurers seek to limit or restrict certain types of discovery, legal research . . . by outside attorneys [the insurers] retain to represent their [policyholders]"). An adversarial relationship between defense counsel and the insurance companies that retained them is, however, unlikely to exist as a stable relationship; reconciliation is the more likely resolution. See *Seeking Common Ground: Insurance Industry Works With DRI to Avert Crisis*, *Lawyers Weekly USA* (May 29, 2000) (discussing agreement between the insurance industry and the Defense Research Institute over "Case Handling Guidelines" to be used by defense counsel retained by insurers to represent policyholders).

the claims adjuster from the insurer. Many courts require the attendance of the claims adjuster or someone from the insurer with authority to compromise the claim at mandatory settlement conferences.

The policyholder's participation in the defense may not be required or even desired. There may be suggestions that the claim is friendly or collusive. In some cases the existence of a preexisting relationship between the claimant and the policyholder may result in the policyholder preferring to be uninvolved in the resolution of the claim. Disassociation may help to immunize the policyholder from any dissatisfaction the claimant realizes as a result of litigation since the policyholder can blame the insurer for the problems.

If the case settles, the settlement will be paid by the insurer. If the case goes to trial, any adverse judgment will be paid by the insurer. In these cases, it is assumed that the results are within the policy limits established by the insurance contract.

Why does the insurer, a non-party to the dispute between the claimant and the policyholder, engage in and perform the above duties? The initial response is that the language of the insurance policy so requires, but why would the insurer place the obligation in the standard form insurance contract in the first place? The consequence is that the insurer, having effective control over the defense of the claim, is deemed bound by the adjudication, even though it is not a party to the action.¹² Control of the defense places the insurer in "privity" with the policyholder, the party of record, and binds the insurer to the result.¹³

Why does the insurer contractually agree to defend the policyholder? Why not simply promise to indemnify the policyholder against litigation losses and leave control of the defense to the policyholder?¹⁴ The costs of defense are

¹² *Montana v. United States*, 440 U.S. 147 (1979):

These interests [protect resources of litigants, conserve judicial resources, foster reliance on judicial decisions] are similarly implicated when nonparties assume control over litigation in which they have a direct financial or proprietary interest and then seek to redetermine issues previously resolved. . . . [T]he person for whose benefit and at whose direction a cause of action is litigated cannot be said to be "strangers to the cause" . . . [O]ne who prosecutes or defends a suit in the name of another to establish and protect his own rights, or who assists in the prosecution or defense of an action in aid of some interest of his own . . . is as much bound . . . as he would be if he had been a party to the record.

¹³ RESTATEMENT (SECOND) OF JUDGMENTS § 39 (1982) (discussing when a party is deemed to be in privity due to control of the litigation). Liability insurers in control of the defense are commonly found to be in privity with their policyholders. *Charter Oak Fire Ins. Co. v. Sumitomo Marine & Fire Ins. Co. Ltd.*, 750 F.2d 267, 270 (3d Cir. 1984).

¹⁴ This is, in fact, the normal procedure in excess insurance policies. Indeed, a significant difference between excess insurance policies and primary insurance policies is that the latter contain first dollar exposure, invariably coupled with a duty to defend the policyholder. Although the excess insurer usually need not provide or participate in the defense of the policyholder, *Sta-Rite Indus., Inc. v. Zurich Re (U.K.) Ltd.*, 178 F.3d 883, 885-86 (7th Cir. 1999), a few exceptions have been recognized by some courts. The excess insurer may be obligated to assume the defense of the policyholder: (1) when an underlying layer of indemnity coverage has been exhausted, *see, e.g.,* *Elas v. State Farm Mut. Auto. Ins. Co.*, 352 N.E.2d 60, 62-63 (Ill. Ct. App. 1976), although this result is aberrational; (2) when the excess policy contains an express promise to defend, *see, e.g.,* *Hocker & Cummins v. N.H. Ins. Co.*, 922 F.2d 1476, 1481-82 (10th Cir. 1991); or (3) when the excess policy is excess to a self-insured retention, *see, e.g.,* *Cooper Labs., Inc. v. Int'l Surplus Lines Ins. Co.*, 802 F.2d 667, 675 (3d Cir. 1986) (again, another decision that is aberrational). Courts have held that

large and are usually not included within the policy limits. Under standard form liability insurance policies, the duty to defend is deemed a supplementary obligation the cost of which is not accrued against policy limits.¹⁵ Thus, if a policyholder has policy limits of \$100,000 per claim, the fact that the insurer may expend \$50,000 defending the claim before the claim is settled for \$100,000, does not reduce the insurer's indemnity obligation. In other words, absent specific policy language to the contrary, the incurred defense costs do not erode or reduce the policy limits available to pay the claim either by way of settlement or judgment satisfaction.¹⁶ Similarly, the fact that the insurer believes that the claim has a value of \$10,000 may still require the insurer to incur a \$50,000 defense unless the insurer can reach a settlement with the claimant. Including a promise to defend in the liability insurance policy appears on the surface to carry no benefit for the insurer. The insurer simply assumes greater costs (defense expenditures) with no upside or positive gain for its efforts.

To see the matter that way would, however, cause us to lose sight of both the benefits of providing a defense and the consequences of not doing so. Insurers are sophisticated parties who have extensive involvement in the civil justice system. Insurers are better situated than the average policyholder to (1) evaluate claims objectively, (2) settle claims effectively, and (3) enjoy the benefits of cost reduction that can be accomplished through volume purchasing of litigation-related services, primarily attorneys' fees.¹⁷

the excess insurer's duty to defend may be triggered by a claim which invades the excess limits when the excess policy obligates the insurer to defend the policyholder. *See, e.g., Celina Mut. Ins. Co. v. Citizens Ins. Co.*, 349 N.W.2d 547, 550-51 (Mich. Ct. App. 1984).

The excess insurer's duty to defend, if any, is determined differently, however, from that of primary insurers. A primary insurer's duty to defend is an express promise of the insurer. The excess insurer's duty to defend arises by operation of contractual provisions, such as "following form" or "ultimate net loss" that do not expressly promise a defense, although the judicial construction of the provision may require the excess insurer to provide a defense. *See infra* note 103.

¹⁵ *See Safety Nat'l Cas. Corp. v. Pac. Employers Ins. Co.*, 927 P.2d 748, 751 (Alaska 1996). This approach may be modified by contract through the creation of an "eroding" or "burning limits" policy. *See, e.g., Lipton v. Lawyers' Mut. Ins. Co.*, 56 Cal. Rptr. 2d 341, 344 (Ct. App. 1996) (noting that the "policies also had a 'burning limits' provision whereby the payment of defense costs would reduce the available limits for each claim after exhaustion of a \$50,000 claim expense allowance"). Other terms for this type of provision include "eroding limits," "self consuming policy," or "defense within limits." *See generally* Shaun McParland Baldwin, *Legal and Ethical Considerations For "Defense Within Limits" Policies*, 61 DEF. COUNS. J. 89 (1994).

¹⁶ *See Safety Nat'l Cas. Corp.*, 927 P.2d at 751; *Helfand v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 13 Cal. Rptr. 2d 295 (Ct. App. 1992), *cert. denied*, 510 U.S. 824 (1993); *cf. Planet Ins. Co. v. Mead Reins. Corp.*, 789 F.2d 668, 672-73 (9th Cir. 1986) (finding that inclusion of defense costs within ultimate net loss provision of policy did not create a "defense within limits" policy).

¹⁷ Marc Galanter, *Why the Haves Come Out Ahead: Speculation On the Limits of Legal Change*, 9 L. & Soc'y REV. 95, 103-04 (1974) (suggesting that experienced litigants, having greater resources, will on average outperform poorer, less sophisticated litigants); *cf. Earle v. State Farm Fire & Cas. Co.*, 935 F. Supp. 1076, 1082 (N.D. Cal. 1996) (finding prejudice arising out of late notice when late notice would impose on the insurer an obligation to reimburse independent counsel at an hourly rate higher than the rate the insurer pays attorneys retained by it in the ordinary course of business). Repeat, experienced litigants may

The standard liability insurance policy also permits the insurer to settle the claim against the policyholder as the insurer "deems expedient." This power to settle allows the insurer to extricate itself from its duty to defend as long as the settlement is for the insurer's account. Thus, the insurer may pay, for its own account, a premium over claim value to avoid a larger defense expenditure that would be incurred in the absence of the settlement. This may be the case even when the insurer settles within the deductible and, therefore, the cost of the settlement is actually borne by the policyholder.¹⁸ Moreover, because the insurer is settling the claim with its own money, it can take its defense costs into account.¹⁹

Adding to the benefits the insurer derives from controlling the defense are the consequences to the insurer of not controlling the defense. A policyholder in control of the defense may lack strong incentives to defend all claims that can be resolved within the indemnity policy limits provided by the insurer. This is particularly true when we look at the policyholder's incentives in terms of "first dollars." The policyholder can cap its losses at its deductible if it offers the policy limits to the claimant immediately. The incentives to do this may be great. A rational policyholder may consider settlement preferable to even a remote possibility of personal liability when the cost of the settlement is borne by another – the insurer. The simplicity of the example would, of course, be distorted in the real world by concerns over strategic bargaining and other considerations. For example, the policyholder may have "reputational" interests that would cause her to reject reasonable settlement proposals because settlement may be perceived as an admission of culpability. Alternatively, the policyholder and the claimant may be linked in such a way (family, business, social, etc.) that the policyholder would be moved by sympathy and self-interest to purchase settlement early in order to end, or forestall, litigation or delayed payment of the claim.²⁰ The average policyholder probably would not be as interested in conserving the policy dollars of the insurer as the policy-

also be less susceptible to the bias against "high risks of low probability" that may induce less experienced defendants to settle claims above the claims' expected value.

¹⁸ See, e.g., *United Capitol Ins. Co. v. Bartolotta's Fireworks Co., Inc.*, 546 N.W.2d 198, 201-02 (Wis. Ct. App. 1996) (noting that the risk that the insurer would "exploit" the policyholder in this situation was limited; that the acquisition by the insurer of the discretionary right to settle was part of the bargain between the parties; and that the discretionary power conferred on the insurer did not violate public policy); see generally Jon Epstein, Annotation, *Liability of Insurer To Insured For Settling Third-Party Claim Within Policy Limits Resulting in Detriment to Insured*, 18 A.L.R.5th 474, 487-88 (1994) (noting that the majority of jurisdictions do not permit a policyholder to escape the obligation to reimburse the insurer for deductibles after the insurer has settled a claim against the policyholder). Some courts have imposed a "good faith" obligation in this context; however, the decisions are few and difficult to reconcile. See *infra* note 21.

¹⁹ *Caplan v. Fellheimer Eichen Braverman & Kaskey*, 68 F.3d 828, 837 (3d Cir. 1995): [T]he language of FEB & K's policy with Vigilant expressly authorizes Vigilant to settle suits as Vigilant deems appropriate. This grant of discretion to Vigilant permits it, in its evaluation of a settlement, to consider factors such as the likelihood of defendants being found liable, the cost to Vigilant of defense of the suit, the impression which various parties and witnesses may make at the trial, the strength of the evidence, and the nuisance value of the claim.

²⁰ William Barker, *Insurer Control of Settlement: Basis and Limitations* 8-9 (1996) (unpublished paper on file with author) (noting that "insureds may be motivated to overpay by considerations extrinsic to the legal obligation insured against: contrition for their involve-

holder would be interested in conserving its own dollars.²¹ Thus, the policyholder would prefer no settlement (*i.e.*, continued litigation) only when the policyholder's perceived costs of settlement (*i.e.*, reputational injury, loss of face, failure to provide money for injury to family or friends, etc.) outweighed the perceived costs of continued litigation (*i.e.*, value of time costs and emotional stress of litigation). The end result would be to raise the average settlement value of cases. If the increase in settlement costs was greater than the costs of defense, insurers would be economically better off including a promise to defend in their liability insurance contracts and factoring the costs of defense into their premium rates.

There are no studies that I am aware of that attempt to quantify the costs and benefits of control over non-control. That is really not surprising. Much of daily life and practice seems to be driven by anecdotal information and intuition. In conditions of uncertainty, coupled with the sound, intuitive belief that policyholders would be freer with their insurers' monies than insurers would be with their own money, risk aversion may induce insurers to avoid the risk of policyholder generosity by exercising control over claims litigation.

Another fact also operates to encourage insurers to provide a defense; even if insurers only provided pure indemnity liability insurance, courts might bind them to the settlements engineered by their free-spending policyholders. Could this happen? It happened in the past as I described in a previous article.²² That development was driven by the exigencies of automobile liability

ment in the injury, desire to compensate an injured friend or relative, or the hope of promoting some other relationship with the claimant").

²¹ In general, insurers may effect "within policy limits" settlements without factoring into the decision the effect of settlement on the policyholder's reputational interest. As between the policyholder and the insurer, the policyholder's interest in avoiding reputation stigma is consistently subordinated to the insurer's financial interest when the insurer is in control of the defense. *See, e.g., Caplan*, 68 F.3d at 837-38 (noting that policyholder's concern over harm to reputation would not support "bad faith" action against the insurer for settlement within policy limits of claim against policyholder); *Charter Oak Fire Ins. Co. v. Color Converting Indus. Co.*, 45 F.3d 1170, 1172 (7th Cir. 1995) (stating majority view is liability insurer does not have duty to handle the claim in a manner that would protect the policyholder from losing its best customer); *W. Polymer Tech., Inc. v. Reliance Ins. Co.*, 38 Cal. Rptr. 2d 78 (Ct. App. 1995) (holding insurer could settle the claim without the consent of the policyholder even though the settlement allegedly injured the policyholder's reputation).

²² *See supra* note 1. The reason for this rule is also explained in RESTATEMENT (SECOND) OF JUDGMENTS § 57 (1980) (stating that when an indemnitor who has *no contractual duty to defend* is given reasonable notice of an action within the scope of the indemnity and an opportunity to assume or participate in the defense, a judgment for the claimant against the indemnitee may be binding on the indemnitor if the indemnitee defended the action with due diligence and reasonable prudence). The reason for this rule is the conservation of judicial resources. *Id.* at cmt. a. When the indemnitor refuses, for reasons other than conflict of interest, to assume or participate in the defense, and the indemnitee defaults, "the indemnitor is estopped to deny the existence and extent of the indemnitee's liability to the injured party"; however, "the indemnitor is free to litigate all the issues that must be determined in establishing his obligation to indemnify . . ." *Id.* at cmt. b. *Cf. Horn Constr. Co. v. MT Sec. Serv. Corp.*, 468 N.Y.S.2d 415, 416 (App. Div. 1983) (holding that indemnitor that resisted inclusion in action brought against indemnitee was bound by a reasonable, good faith settlement of that action by the indemnitee).

litigation and the brooding omnipresence of Financial Responsibility Laws.²³ While that aggregation of facts cannot be duplicated across the range of liability insurance contexts, it was perhaps enough to resolve the issue for insurers, at least at the working, first layer coverage limits.²⁴ The use of pure indemnity liability insurance at the working layer of coverage may have been perceived as a risk too great to run given the precedent established in the automobile liability cases. In any event, the promise to defend proved popular and the costs of providing that coverage are ultimately borne by the policyholder through the premiums charged.²⁵ As long as the costs of defense can be adequately quantified by good underwriting, it is reasonable for insurers to provide the additional defense coverage. Indeed, it is only with the recent significant rise in defense costs that this perspective has been subject to reconsideration through the creation of "eroding limits" policies. In the end, insurers generally find it is in their economic interest to control the defense of the claim rather than relinquish it to the policyholder. That is why "control" is the hallmark of the standard case and why insurers include a promise to defend in standard liability insurance policies.

If the insurer provides the defense, what consequences does this have on the insurer's indemnity obligations when settlement efforts fail and the claim results in a judgment against the policyholder? In this posture, the claimant/

²³ This is an area where the desire to compensate victims through an insurance mechanism has received express judicial acknowledgment and approval. See, e.g., *State Farm Mut. Auto Ins. Co. v. Ragatz*, 571 N.W.2d 155, 159 (N.D. 1997) (stating the Financial Solvency Legislation creates a strong incentive to construe automobile liability policies to provide compensation for victims of policyholder negligence in connection with the operation of motor vehicles); *Jeffreys v. Snappy Car Rental, Inc.*, 493 S.E.2d 767, 769 (N.C. Ct. App. 1997) (stating that the primary purpose of Financial Solvency Legislation is to provide compensation to victims of accidents).

²⁴ We should not ignore the impact of automobile accident litigation in the development of liability insurance law. The sheer volume of automobile accident cases, estimated to constitute approximately one third of filed civil cases, makes them the "army ants" of the civil justice ecosystem. Roger Hanson et al., *What is the Role of State Doctrine in Understanding Tort Litigation?*, 1 MICH. L. & POL'Y REV. 43, 57-58 (1996) (stating that automobile accident cases constitute thirty-five percent of general civil filings (tort, contract, and property) in fault jurisdictions and twenty-three percent of the filings in non-fault jurisdictions); JAMES KAKALIK & NICHOLAS PACE, COSTS AND COMPENSATION PAID IN TORT LITIGATION 131-32 (Rand Corp. Inst. for Civil Justice ed. 1986) (automobile accident cases constituted fifty-five percent of civil jury verdicts in state courts and sixteen percent of civil jury verdicts in federal courts). This latter figure is significant given that only about two percent of filed civil cases go to jury trial. Samuel Gross & Kent Syverud, *Getting to No: A Study of Settlement Negotiations and the Selection of Cases For Trial*, 90 MICH. L. REV. 319, 393 (1991).

²⁵ Insurers often provide expanded coverage when the market demands it. Insurers, like all other producers, must respond to market demands if they wish to sell their product. See, e.g., Michael Bradford & Judy Greenwald, *Reinsurers Show Their Primary Colors: Insurers Wary as Soft Market Leads Reinsurers to Compete For Some Business*, BUS. INS., Nov. 10, 1997, at 26. Michael Bradford, *10 Largest U.S.-Based Insurance Wholesalers: Crump Insurance Services Inc.*, BUS. INS., Sept. 15, 1997, at 49 (noting that providing new products and programs was the reason Crump was able to increase premium volume in soft insurance market). Susanne Sclafane, *Take "Notice" of D&O Policy Language*, NAT'L UNDERWRITER PROP. & CASUALTY-RISK & BENEFITS MGMT., Sept. 15, 1997, at 22 (noting that in soft commercial insurance market insurers are providing broader notice provisions more favorable to policyholders in order to secure business).

judgment creditor can now garnish the insurance policy as an asset of the policyholder.²⁶ In a typical garnishment action, the garnishee can litigate whether there is a "debt." In the context of liability insurance, the "debt" is the coverage obligations of the insurance contract.²⁷ Even a short perusal of the standard liability insurance policy will indicate that the standard form insurance contract does not promise coverage for any and all claims. Some claims fail to come within the coverage initially promised; for example, the loss may not "occur" within the policy period,²⁸ may not involve a person insured under the

²⁶ Most jurisdictions have "no action" statutes or enforce "no action" clauses that preclude an action by a claimant until the policyholder's liability has been legally determined. See JERRY, *supra* note 1, § 84[b] (noting that the general rule in the United States is that claimant does not possess a direct right of action against the insurer).

²⁷ Cf. Nat'l Mem'l Servs. v. Metro. Life Ins. Co., 49 A.2d 382 (Pa. 1946):

After a loss has occurred, the right of the insured or his successor in interest to the indemnity provided in the policy becomes a fixed and vested right; it is an obligation or debt due from the insurer to the insured, subject only to such claims, demands, or defenses as the insurer would have been entitled to make against the original insured.

Id. at 383 (citation omitted). The decision involved the insurer's unsuccessful attempt to enforce a non-assignment of rights provision in the insurance contract. When garnishment is sought under a direct action statute, *supra* note 26, the claimant's interest in the policy is often said to have vested at the moment of injury. See *Cushing v. Md. Cas.*, 198 F.2d 536, 539 (5th Cir. 1952), *vacated on other grounds*, 347 U.S. 409 (1954); see also *Morewitz v. W. of England Ship Owners Mut. Prot. & Indem. Assoc. (Luxembourg)*, 62 F.3d 1356, 1362-63 (11th Cir. 1995) (noting that under Alabama statute injured claimant could maintain direct action against insurer for policy benefits). That interest may, however, be affected by post-loss actions by the policyholder and the insurer. Compare *Reagor v. Travelers Ins. Co.*, 415 N.E.2d 512, 516 (Ill. App. Ct. 1980) (stating that a post-loss agreement between the policyholder and the insurer that the loss is not covered, entered into before the policyholder is determined to be liable to the claimant, is not binding on the claimant). The court noted:

As a beneficiary of a liability insurance policy, an injured person has rights under the policy which vest at the time of the occurrence giving rise to his injuries. Moreover, he is a real party in interest to the liability insurance contract. The injured person must be given the opportunity to litigate the question of coverage under the liability insurance policy before his interest in the insurance may be terminated. Thus, where an insurer brings a declaratory judgment action to determine coverage of a claim made against its insured, the injured person is a necessary party to the suit, and the injured person may appeal from a judgment that there is no coverage.

Id. at 514 (citations omitted), with *Estate of Shoff v. Estate of Zimmerman*, 1998 WL 887227 (Ohio Ct. App. Dec. 16, 1998) (unpublished) (holding that settlement between claimant and policyholder absolved the insurer of coverage obligations and noting that "[w]hile an injured party has a 'substantial' right on the tortfeasor's policy from the time of injury that right is not vested until a judgment against the tortfeasor is secured") (citation omitted).

²⁸ Standard general liability insurance provides coverage for bodily injury resulting from an occurrence; occurrences are in turn defined as: "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." Insurance Services Office Commercial General Liability Coverage Form (1982, 1984), reprinted in ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES*, app. J(1), at 1157 (Student ed. 1988). The overwhelming rule in the United States is that, for insurance coverage purposes, in the typical case an accident occurs not when the loss engendering act occurs but when the injury or harm results from that loss engendering act. See, e.g., *Schrillo Co. v. Hartford Accident & Indem. Co.*, 226 Cal. Rptr. 717, 720-21 (Ct. App. 1986). If the injury or harm that forms the basis of the claim occurred after the policy period concluded, the claim would not be covered for indemnity purposes. See, e.g., *BVMI v. Ind. Indemn. Co.*, 104 Cal. Rptr. 2d 557, 560-61 (Ct. App. 2001).

policy,²⁹ or may not fall within the coverage promised.³⁰ Other claims, while falling within the initial scope of coverage, may be subsequently excluded from coverage.³¹ Can the insurer, which has accepted the tender and assumed control of the defense, contest the garnishment action by asserting that the claim for which judgment was entered is not a covered claim; therefore, there is no "debt"? The usual answer is that the insurer, which controls the defense, cannot contest coverage.

The reason the answer is usually "no" is frequently misunderstood. Unlike the situation with regard to the merits of the underlying claim, the bar to contesting whether the claim is covered under the insurance policy is not purely a consequence of "privity." The insurer's inability to contest coverage is a legal consequence that arises from a combination of several related factors: (1) the insurer's decision to accept the tender; (2) the insurer's assumption of the defense of the policyholder; and (3) the insurer's control over the conduct of the defense to the claim on behalf of, and to the exclusion of, the policyholder. "Privity" arising out of the control of the defense bars the insurer from litigating the existence and extent of the policyholder's liability to the claimant that was resolved in the underlying litigation brought by the claimant. "Privity" arising out of control of the defense does not, by itself, however bar the insurer from litigating the issue of coverage.

In some cases, litigation of facts relevant to coverage may be barred under principles of privity and collateral estoppel.³² This occurs when factual issues relating to the underlying claim are also dispositive of the coverage issue. For example, the underlying claim may be for assault and battery and the insurance policy may have an Assault and Battery or Intentional/Expected Act exclusion. In this context, the facts relating to the merits of the claim overlap with those pertinent to the issue of coverage of that claim. Because collateral estoppel bars relitigation of facts, not theories of recovery or causes of action, the resolution of the merits of the claim may bar relitigation of facts pertinent to the coverage of the claim. This application of collateral estoppel would not, however, pick up cases when there was no overlap, as when the coverage defense is based on whether the policy was valid or in effect or whether the defendant was an insured. For example, the insurer may contend that the insurance policy is

²⁹ See, e.g., *Sears, Roebuck & Co. v. Commercial Union Ins. Co.*, 982 S.W.2d 151, 155 (Tex. App. 1998) (holding that insurer did not breach duty to defend a party (tenant) who was not a named insured under the insurance contract between the insurer and the landlord of the tenant).

³⁰ *Kepler v. Am. Family Mut. Ins. Co.*, 588 N.W.2d 105 (Iowa 1999) (holding that liability coverage based on "use" of a vehicle was not met in situation when dog bit child while both were in the policyholder's parked vehicle).

³¹ *Armed Forces Ins. Exch. v. Transamerica Ins. Co.*, 966 P.2d 1099, 1107 (Haw. Ct. App. 1998) (applying "business pursuits" exclusion in homeowner's liability insurance policy to claim against policyholder for sexual harassment); *Cook v. Evanson*, 920 P.2d 1223, 1226 (Wash. Ct. App. 1996) (holding that pollution exclusion barred coverage for claim of injury resulting from policyholder's negligence that allowed fumes to escape).

³² When coverage facts overlap liability facts the insurer's control of the defense collaterally estops it from relitigating the adjudicated facts. See, e.g., *Preferred Am. Ins. v. Dulceak*, 706 N.E.2d 529, 533 (Ill. App. Ct. 1999) (holding that insurer which controlled defense of its policyholder could not relitigate policyholder's negligence in subsequent uninsured motorist arbitration); see also *infra* note 39.

avoided by reason of the policyholder's misrepresentations in the insurance application or the policyholder's failure to satisfy conditions to coverage, such as the duty to give timely notice and/or cooperate in the defense of the suit. The insurer may contend that the party claiming coverage does not fall within the definition of who is an insured under the insurance contract. It is unlikely that the *facts* of these coverage defenses would be litigated in the resolution of the merits of the underlying claim. Even if there is some factual overlap at the margin, barring litigation of those "facts" in the coverage action may be perceived as unfair.³³

The insurer is foreclosed from contesting its obligations by its "unconditional" acceptance of the tender. "Unconditional acceptance" bars the insurer from later taking the inconsistent position that the claim is not covered. The basis for this rule is said to lie in "waiver," "estoppel," or "election." In fact, it is difficult to make an exact fit between any of the above if one uses the formal definition of the concept as a guide.³⁴ There is, nonetheless, a consistent theme in the cases that it would simply be inequitable to permit the insurer to exercise the benefits of controlling the defense while avoiding the consequences of that exercise.³⁵ The argument is, however, usually not advanced in judicial decisions beyond the bare assertion that fairness demands that the insurer unconditionally performing its defense obligation not be allowed to contest its indemnity obligation.

The counter-argument that the unconditionally defending insurer should be allowed to contest coverage, rests largely on the perception that the policyholder is not factually aggrieved by allowing the insurer to contest coverage when coverage facts are different from liability facts. Under this view, the policyholder has not sustained harm or injury resulting from the insurer's providing a defense; rather, the policyholder has simply received a contract benefit, the promised defense. The promise to defend is, however, a distinct and different contract benefit from the promise to indemnify. Allowing the insurer to contest indemnity coverage neither adds to nor detracts from the "rights" secured to the policyholder under the insurance contract. Performance of one contractual obligation (defense) should not be seen as requiring the performance of all

³³ See RESTATEMENT (SECOND) OF JUDGMENTS § 28(5)(b) (1982) (stating that preclusive effect to a prior determination will not be given when "it was not sufficiently foreseeable at the time of the initial action that the issue would arise in the context of a subsequent action").

³⁴ ROBERT KEETON & ALAN WIDISS, INSURANCE LAW § 6.1(b) (2d ed. 1988) (arguing that doctrines of waiver and estoppel have been used instrumentally by courts to justify coverage decisions those courts believed were fair, just, and reasonable under the circumstances). The most popular theory is equitable estoppel. See, e.g., *Nationwide Mut. Ins. Co. v. Filos*, 673 N.E.2d 1099, 1104 (Ill. App. Ct. 1996) (noting that when the insurer unconditionally defends the policyholder, the insurer is estopped to contend that the non-covered claim is outside the scope of the coverage promised by the policy); see also *Transamerica v. IBC*, 94 F.3d 1204, 1207-08 (8th Cir. 1996) (same); *Safeway Managing Gen. Agency v. Cooper*, 952 S.W.2d 861, 867-68 (Tex. App. 1997) (noting exception to "no estoppel into coverage" rule when the insurer assumes the unconditional defense of the policyholder).

³⁵ See, e.g., *Cont'l Cas. Co. v. Hartford Fire Ins. Co.*, 116 F.3d 932, 939 n.8 (D.C. Cir. 1997); *Nationwide*, 673 N.E.2d at 1104. There are some contrary decisions, but they constitute a distinct minority view. *Essex Ins. Co. v. Stage 2, Inc.*, 14 F.3d 1178, 1182 (7th Cir. 1994) (refusing to bar the insurer on equitable estoppel grounds from denying coverage after accepting tender unconditionally).

other contractual obligations, particularly when, as here, the obligations are distinct and triggered by different factual arrays.³⁶

It may also be asserted that the policyholder's loss of control over the defense supports the bar to the insurer contesting indemnity coverage. This position ignores, however, that the reason the policyholder lost control was that it requested the insurer to assume control. Having voluntarily surrendered control to the insurer, the policyholder is hardly in an advantageous position to claim that it "lost" something. The insurer's position that acceptance of the defense should not prejudice its right to contest indemnity coverage is enhanced, moreover, by the recognition that the defense obligation is broader than the indemnity obligation in that the insurer may have to provide a defense because of the possibility of coverage, but not provide an indemnity because in actuality the claim is not covered. In effect, the "loss of control" argument bootstraps the insurer; the obligation to defend subsumes the obligation to indemnify.

Estopping the unconditionally defending insurer from contesting coverage has also been sustained on fairness justifications related to disclosure. When the policyholder tenders the defense to the insurer, courts have imposed the requirement that the insurer disclose the terms under which it will "accept" the tender.³⁷ As originally formulated, this requirement rested on a formal, "either-or" view of rights created by the insurance contract. Either the policyholder was contractually entitled to an unconditional defense or she was not; there was no middle ground the insurer could occupy under the insurance contract. The policyholder could put the insurer to an election between an unconditional defense and a rejection of the tender. A conditional defense required some form of assent on the part of the policyholder, although assent was often implied.³⁸ While this "forced election" approach has been largely discarded in favor of giving the insurer the power to defend conditionally or unconditionally,³⁹ the "assent" approach was consistent with the disclosure justification for

³⁶ The duty to defend is usually triggered by the "possibility" that an asserted claim against the policyholder is covered by the insurance contract. *First Ins. Co. of Hawaii, Inc. v. State*, 665 P.2d 648, 653 (Haw. 1983). The duty to indemnify is, however, determined by adjudicated facts, not allegations. Moreover, while the insurer need only indemnify those claims found to be within coverage, the insurer must defend the entire suit even if only a portion of the suit raises a possibly covered claim. Ellen Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1, 23-24 (1999) (noting the general rule that "if only one of the claims contained in the lawsuit triggers the duty to defend, the insurer must provide a defense with respect to the entire claim because, in general, it is not possible to defend only the potentially covered claim") (footnotes omitted).

³⁷ *Kirschner v. Process Design Assoc.*, 592 N.W.2d 707, 709 (Mich. 1999) (stating that "when an insurance company undertakes the defense of its insured, it has a duty to give reasonable notice to the insured that it is proceeding under a reservation of rights, or the insurance company will be estopped from denying its liability"); cf. *Bluestein & Sander v. Chicago Ins. Co.*, 276 F.3d 119, 122 (2d Cir. 2002) (applying New York law, holding that prejudice to insured may be presumed when insured loses control of the defense to unconditionally-defending insurer).

³⁸ *Gossard v. Ohio Cas. Group of Ins. Cos.*, 35 Cal. Rptr. 2d 190, 191 (Ct. App. 1994) (noting that the policyholder's silence to the insurer's notice of providing a conditional defense will be deemed "acquiescence").

³⁹ See *infra* note 89 and accompanying text. The policyholder may reject the conditional defense and assume control of the defense; however, such a course of conduct is usually

estopping the unconditionally defending insurer. If the insurer could withhold disclosing whether it would contest coverage, (in other words, conditionally defend), the policyholder's right to force the insurer to obtain the policyholder's "assent" to a conditional defense would be lost. Recognition of the policyholder's right to force the insurer (1) to elect to defend unconditionally, (2) to reject the tender, or (3) to secure the policyholder's consent to a conditional defense imposed a correlative duty of disclosure on the insurer, *i.e.*, the insurer must declare its position at the outset, not play cat and mouse with the policyholder. Although the movement away from recognizing a right in the policyholder to force the insurer to elect between an unconditional defense or rejection of the tender undermines the estoppel theory, the estoppel argument is deeply ingrained in insurance law and remains the dominant position.⁴⁰

deemed to be for the policyholder's account. See *Finley v. Home Ins. Co.*, 975 P.2d 1145 (Haw. 1998):

[T]he right to refuse an insurer's tender of a defense under a reservation of rights is mandated by the HRPC. See HRPC Rule 1.8(f), stating that "[a] lawyer shall not accept compensation for representing a client from one other than the client unless: (1) the client consents after consultation[.]" The requirement of client consent necessarily implies the right not to consent. Therefore, if the client does not desire the representation under the terms offered by the insurer, the insurer must either choose to defend unqualifiedly or allow the insured to conduct its own defense of the action.

If the insured chooses to conduct its own defense, the insured is responsible for all attorneys' fees related thereto. The insurer is still potentially liable for indemnification for a judgment within the scope of insurance coverage. However, having refused the contractual terms of the policy, the insured foregoes its right to compensation for defense fees. A contrary holding would effectively nullify our determination that the insurer, even in a reservation of rights situation, retains the contractual right to select the counsel whom it will pay to defend the insured.

Id. at 1155.

⁴⁰ Approximately forty-two states recognize and apply estoppel theory to bar an unconditionally defending insurer from contesting indemnity coverage, although some of these jurisdictions also rely on the related concept of waiver. See Robert Heist, *The Tripartite Relationship and the Insured's [sic] Duty to Defend Contrasted With Its Desire to Manage and Control Litigation Through the Introduction of the Legal Audit*, Appendix State Survey on Duty to Defend, 602 PLI/LIT 221, 249-362 (April 1999).

The full extent of the insurer's estoppel is unclear. The issue is presented most forcefully when the judgment involves covered and uncovered claims. Some courts have permitted an allocation, but have placed the burden of making the allocation on the insurer. Guidance as to how such an allocation would be made has been lacking. Some decisional law has arisen in the context of policy limits. In *Buckley v. Orem*, 730 P.2d 1037 (Idaho Ct. App. 1986), the insurer sought a declaration of its liability on an unallocated verdict against its policyholder when it appeared that the liability of its policyholder might exceed the policy's \$100,000 *per person* limits as to one of the claimants. If the insurer was successful it could limit its responsibility by capping its indemnity obligation at \$100,000 as to that claimant. Any excess or difference between the \$100,000 and the amount of the total verdict *allocated* to that claimant would be borne by the policyholder. The court held that the insurer could allocate under these circumstances if it could "[produce] evidence showing a substantial likelihood of overpayment should the unallocated verdict be paid." *Id.* at 1042 (collecting cases and describing its approach as the majority rule); see *Magnum Foods, Inc. v. Cont'l Cas. Co.*, 36 F.3d 1491, 1498 (10th Cir. 1994) (holding that insurer which undertakes control of the defense has the duty "not to prejudice the insured's rights by failing to request special interrogatories or a special verdict in order to clarify coverage of damages"); but cf. *Villicana v. Evanston Ins. Co.*, 33 Cal. Rptr. 2d 690, 699 (Ct. App. 1994), *ordered not published* per Rules 976, 977, California Rules of Court (Jan. 19, 1995) (stating that

This is a weak doctrinal justification for preventing the unconditionally defending insurer from contesting indemnity coverage. The bar rests fundamentally on the perception that the insurer *ought* to affirmatively disclose to the policyholder concerns the insurer has that would support a no-coverage position regarding indemnity. The assertion of these concerns by the insurer would, however, constitute a conditional defense, a position inconsistent with that actually taken by the insurer. There is much circuitry to the argument; nonetheless, the basic concern that the insurer disclose its intended position resonates well with courts.⁴¹ Thus, it is not surprising that the unconditionally defending insurer is deemed bound by its position notwithstanding the doctrinal shortcomings of the rule. The practical consequence of the privity and estoppel doctrines is that the unconditionally defending insurer will usually have no defense in a garnishment action.

The legal consequences of taking the claim to judgment directly influences the insurer's decision to settle short of judgment. The insurer will be bound to pay any judgment up to policy limits; therefore, the insurer has an incentive to settle whenever its anticipated defense costs (which are not subject to policy limits) and its indemnity obligation regarding the expected judgment (which are subject to policy limits) are greater than a settlement it can now strike with the claimant. There are, of course, other factors, such as the respective risk aversion of the claimant (and his attorney), relationships between the parties (for example, is the policyholder a valued customer of the insurer), blandishments by the settlement judge (some judges create settings which facilitate settlement; other judges are not as effective), attitudes of the parties (either the claimant or his attorney or the insurer may prefer litigation over settlement because they wish to send a message to the other side or see the case as establishing a favorable precedent). While these sundry factors may be present in an individual case, the factors appear sporadically in the cases. The insurer must, however, in every case balance its actual and immediate "out of pocket" costs of an early termination of the case through settlement with the claimant against the expected "actual costs" of non-termination of the case, *i.e.*, continued defense costs and an adverse award having a determinable present, expected value. Liability insurers quantify these costs and assess the cost-benefit relationship between immediate settlement and continued defense.

If the claim settles, the insurer will pay the settlement, again assuming it is within policy limits, and even in some cases when the settlement exceeds policy limits, to prevent the case from transmuting into a case having a "bad faith" exposure.⁴² The insurer's post-tender decision-making regarding settle-

insurer's use of "special interrogatories" while in control of defense would be evidence of "bad faith"), *modified by* 29 Cal. App. 4th 489b (1994).

⁴¹ See *Kirschner*, 592 N.W.2d at 709 (noting that when an insurer undertakes the defense of its insured, the insurer has a duty to give reasonable notice to the insured that it is providing a conditional defense or the insurer will be estopped from contesting indemnity coverage); see *infra* notes 135-37 and accompanying text (suggesting pragmatic reasons for requiring disclosure by the insurer of its coverage position).

⁴² The insurer's discretionary *right* to settle must be distinguished from its implied *duty* to settle. An insurer breaches its duty to the policyholder if (1) the insurer has assumed control of the defense of its policyholder under a liability insurance policy, (2) there is both a risk of an excess judgment and an opportunity to settle, and (3) the insurer fails to settle a claim that

ment of the claim is not a product of specific contractual language. Settlement decision-making by the insurer is posterior to the treatment of the case as within or outside the standard relationship. By the time the insurer has reached the position where it can settle the claim, it has already acted in a way that will cause the claim to be treated as standard or non-standard. The decision to defend conditionally or unconditionally is usually made when the claim is first tendered to the insurer.⁴³ Having elected to defend unconditionally, the insurer must now make settlement decisions given the legal consequences imposed by having assumed an unconditional defense.

The rational, unconditionally defending insurer's willingness to pay is a function of the consequences of a failure to settle arrayed against a settlement that will conclude further litigation and determine the insurer's financial exposure for the claim. The calculation is driven by the reality that the insurer will be bound by a judgment entered against the policyholder. If the insurer could litigate, without penalty, its coverage obligations after having given its unconditional assent to the tender, this would likely affect settlement rates, although in which direction and to what extent is difficult to say. The claimant, or the policyholder, would have to compensate the insurer for surrendering its right to contest coverage. This would reduce the costs of settlements for insurers. On the other hand, the claimant would be less interested in accepting a discount of its claim against the policyholder absent assurance that the settlement would be paid in a timely fashion. This expectation would tend to reduce the number of settlements.

The standard relationship's key features then are that the insurer has (1) unconditionally accepted the tender and (2) assumed control of the defense. These two features drive the legal doctrines that tie the insurer to judgments entered against the policyholder and bar insurers from interposing coverage defenses in garnishment actions to satisfy the judgment against the policyholder. These legal "facts of life" influence unconditionally defending insurers to fund settlements in those situations when settlement is preferable to further litigation.

A claim does not come pre-marked as within the standard relationship between policyholder and insurer. That characterization is a consequence of

is within the policy limits without lawful cause. *See, e.g., Crisci v. Sec. Ins. Co.*, 426 P.2d 173, 177-78 (Cal. 1967). Today, almost all jurisdictions recognize extracontractual remedies for this type of settlement practice. *See* Stephen Ashley, *BAD FAITH ACTIONS*, App. II (1984) (summarizing bad faith law in each state). *See generally* Syverud, *supra* note 6, at 1120 n.14 (noting that forty-seven states allow insureds to sue for the failure to settle). Payment of the excess policy limits verdict by the insurer may not preclude a "bad faith" action when the insurer unreasonably rejected a within-limits settlement offer. *See, e.g., Birth Center v. St. Paul Cos., Inc.*, 787 A.2d 376, 379 (Pa. 2001); *Critz v. Farmer's Ins. Group*, 41 Cal. Rptr. 401, 405 (Ct. App. 1964); *but see* *Fid. & Cas. Co. of N.Y. v. Cope*, 462 So. 2d 459 (Fla. 1985) (*contra*).

⁴³ The insurer may be allowed to change its initial position. Moving from a conditional to an unconditional defense does not present a problem. The same cannot be said for the movement from an unconditional to a conditional defense. To justify the change the insurer must be able to point to some fact or event that it was not aware of and reasonably could not have been aware of when it accepted the tender unconditionally. Moreover, the insurer must demonstrate that it did not use its control of the defense to discover the facts or events on which its conditional defense is based.

how the insurer responds to the tender. If the insurer accepts the tender unconditionally and controls the defense, the claim is within the standard case. It can be expected that the more obvious it is that a claim is within coverage and can be resolved within policy limits, the more likely it is that the insurer will respond to the tender unconditionally. On the other hand, the less likely it is, as perceived by the insurer, that the claim is covered or can be resolved within policy limits, the more likely it is that the insurer will respond to the tender in a manner that causes the claim to be identified as non-standard. Much of the tension in the decisional law is represented by instrumental doctrine that imposes economic sanctions on insurers to induce insurers to treat claims, as to which they have legitimate coverage doubts, as within the standard case. This is the inevitable consequence of a rule that seeks to discourage insurers from using rejection for strategic purposes vis-à-vis policyholders or claimants. A rule is necessarily objective in approach and thus over-inclusive when directed at a problem that is, at root, subjective. If the expected cost resulting from treating the claim as non-standard is greater than the expected cost resulting from treating the claim as standard, the insurer will be induced to accept the tender unconditionally. The different expectations reflect the fact that the insurer's view of the coverage dispute may not be shared by the court or jury. The chance that the court or jury will disagree with the insurer or treat the insurer's coverage position as unreasonable is another legal "fact of life" the insurer must factor into its decision whether to accept or reject the tender.

III. THE NON-STANDARD CASE: INSURER BREACH OF THE DUTY TO DEFEND

Courts frequently state that the duty to defend is broader than the duty to indemnify.⁴⁴ This means the insurer will frequently be required to defend the policyholder in a lawsuit even though it is uncertain, and occasionally even unlikely, that upon resolution of the litigation, the insurer will be required to cover the judgment, *i.e.*, provide indemnity coverage. Moreover, absent appropriate policy language the insurer cannot "buy" its way out of an expensive defense by depositing the policy limits in court, interpleading its policy limits, or paying the policy limits directly to the claimant, unless that payment concludes the litigation between the claimant and the policyholder.⁴⁵ A defense

⁴⁴ First Bank of Turley v. Fid. & Deposit Ins. Co. of Md., 928 P.2d 298, 303 n.10 (Okla. 1996) (collecting decisions).

⁴⁵ The standard requirement is that only payments of judgments and settlements are counted against policy limits. Gross v. Lloyds of London Ins. Co., 358 N.W.2d 266, 270 (Wis. 1984) (holding that tender of policy limits without securing release of policyholder is not an actual settlement and is therefore ineffectual in exhausting policy limits and extinguishing insurer's duty to defend); *see also* Aetna Cas. & Sur. Co. v. Sullivan, 597 N.E.2d 62, 64 (Mass. Ct. App. 1992) (same, but distinguishing case involving multiple claims and valid policy limits settlement and release with less than all claimants); *compare* Simmons v. Farmers Ins. Group, 877 P.2d 1255, 1258 (Utah Ct. App. 1994) (enforcing provision allowing insurer to terminate defense on payment of policy limits); Am. States Ins. Co. of Tex. v. Arnold, 930 S.W.2d 196, 200-01 n.1 (Tex. Civ. App. 1996) (collecting cases). An insurer which settles a claim without securing a complete release of its policyholder may incur "bad faith" exposure. Strauss v. Farmers Ins. Exch., 31 Cal. Rptr. 2d 811, 813 (Ct. App. 1994); *see also* Fama v. Metro. Prop. & Cas. Ins. Co., 646 N.Y.S.2d 930, 933 (Sup. Ct. 1996).

paid for by the insurer has obvious economic value for the policyholder and for the claimant. An insurer, which knows that its policy limits will be exhausted by a claim but still cannot escape continuing to pay for a defense, has an incentive to contribute some of its anticipated defense costs to a settlement that will excuse the insurers continued participation in the claim.⁴⁶

The duty to defend arises out of a promise made by the insurer. To a much greater extent than the promise to indemnify, to which a third party may claim some interest, the duty to defend is owed solely to the policyholder,⁴⁷ even while, as noted previously, the duty to defend may have economic value to the claimant. While insurers would no doubt prefer that courts view the promise to defend more narrowly as solely derivative of the promise to indemnify, courts have taken a much broader perspective and have identified the promise to defend as a separate, independent form of coverage, in effect, "defense" or "litigation" insurance.⁴⁸ Thus, an insurer may breach its duty to defend even if it is later determined that no indemnity coverage in fact exists, if the jurisdiction's rules nonetheless obligate the insurer to provide a defense. For example, a jurisdiction, which obligates an insurer to provide a defense whenever the tendered claim is "potentially covered" under the insurance policy's indemnity coverage, does not excuse that duty because it is subsequently determined that no coverage in fact existed. The duty to defend is excused under this test only if the insurer establishes there is no potential that the claim is covered.⁴⁹

The insurer's duty to defend is activated by the tender of a claim within coverage. It is irrelevant whether the claim is meritorious or groundless:⁵⁰ the focus is on coverage. The test is simple: if the claim were true, would it be

⁴⁶ This may create incentives for risk-seeking claimants who may attempt to collect a portion of the defense costs from the insurer by way of settlement. See Chris Guthrie, *Framing Frivolous Litigation: A Psychological Theory*, 67 U. CHI. L. REV. 163 (2000) (contending that risk-seeking plaintiffs will consistently best risk-adverse defendants because these plaintiffs have psychological leverage, which they will rationally exploit to induce defendants to settle at amounts above the claim's true expected value).

⁴⁷ Only the policyholder can claim a breach of the duty to defend. *Jane Doe v. Ordinary Mut.*, 38 Cal. Rptr. 2d 131, 135 (Ct. App. 1995) (noting that a third-party claimant may not bring an action against the insurer for breach of the duty to defend absent an assignment of that right from the policyholder). This means, however, that it is the policyholder's claims that may be asserted, not the claimant's. See *Maynard v. Sauseda*, 329 N.W.2d 774, 780 (Mich. Ct. App. 1982) (rejecting breach of duty to defend claim that was assigned to the claimant by the policyholder when the claimant sought recovery based on his attorney's fees expended rather than the policyholder's), *vacated and on remand* 130 Mich. App. 445 (1983); *Quam v. Wulfekuhle*, 390 N.W.2d 472, 474 (Minn. Ct. App. 1986) (noting that the insurer's defense of the policyholder creates a coverage estoppel argument that is available only to the policyholder, not the claimant).

⁴⁸ Pryor, *supra* note 36, at 4; Fischer, *supra* note 1, at 145.

⁴⁹ See, e.g., *Montrose Chem. Corp. v. Superior Court*, 861 P.2d 1153, 1157 (Cal. 1993).

⁵⁰ See *Reese v. Travelers Ins. Co.*, 129 F.3d 1056, 1060-61 (9th Cir. 1997) (holding that extrinsic factual evidence cannot excuse the insurer's duty to defend when a covered claim is specifically pled even though: (1) the extrinsic evidence shows the claim is excluded from coverage; and (2) the extrinsic evidence shows the claim is groundless). The extrinsic factual evidence involved the "owned property" exclusion and evidence that contamination had not actually occurred to property of another notwithstanding a contrary allegation. *Id.* at 1060.

within coverage? If the answer is "yes," the insurer must provide a defense. The allegations are broadly construed in support of the contention that the claim is covered.⁵¹ Coverage possibility is determined based upon the facts as they appear or are known to the insurer at the time of the tender. In other words, the insurer cannot reject a tender and then engage in an after the fact effort to backdate a justification for the rejection.⁵² In this regard, the insurer's ability to reject a tender or discontinue a defense may be restricted even to the extent the insurer may use the product of its coverage investigation to escape its defense obligation. For example, when a claim within coverage is pled, the fact that the insurer accurately determines through an investigation that the claim is meritless may not excuse the duty to provide a defense.⁵³ Even the claimant's stated intent not to assert a claim within coverage may not relieve a insurer of its duty to defend.⁵⁴

⁵¹ *Roman Catholic Diocese of Springfield, Ill. v. Md. Cas. Co.*, 139 F.3d 561, 565 (7th Cir. 1998) (noting that all doubts as to coverage, insofar as the duty to defend is concerned, are resolved against the insurer).

⁵² *Haskel, Inc. v. Superior Court*, 39 Cal. Rptr. 2d 520 (Ct. App. 1995) (holding that it is the duty of the insurer to undertake the defense unless it can confine the claim to a recovery the policy does not cover). After accepting the tender the insurer may learn that the claim is not covered. In that situation the insurer may bring a declaratory relief action to secure a decision that it has no duty to defend and it may rely on post tender developed evidence, subject to certain limitations. *See, e.g., Parsons v. Cont'l Nat'l Am. Group*, 550 P.2d 94 (Ariz. 1976) (holding that the insurer could not base a coverage denial on evidence obtained by a lawyer the insurer selected to represent the policyholder in the underlying litigation). Until the insurer secures a non-coverage decision in the declaratory relief action, it must continue to provide a defense. *Liberty Mut. Ins. Co. v. Metzler*, 586 N.E.2d 897, 902 (Ind. Ct. App. 1992) (noting that if the insurer decides it has no duty to defend, it must protect its interest by filing a declarative relief action or conditionally defend; the insurer refuses to defend at its peril).

The converse is not the rule. Knowledge may bring a claim within the duty to defend. *Am. States Ins. Co. v. Natchez Steam Laundry*, 131 F.3d 551, 553 (5th Cir. 1998) (noting that under Mississippi law, duty to defend attaches even when no claim within coverage is asserted when insurer has actual or constructive knowledge of the existence of facts that would trigger coverage and the duty to defend).

⁵³ *Reese v. Travelers Ins. Co.*, 129 F.3d 1056, 1061 (9th Cir. 1997) (holding that when claimant alleged damage to property other than the policyholder's, insurer's investigation which determined that injury was limited to policyholder's own property, and thus within "owned property exclusion" in the insurance policy, did not relieve insurer of its defense obligation triggered by the *pleaded claim*). While *Reese* states the rule, the approach has been criticized. *See Pryor, supra* note 36, at 16-18 (criticizing approach that decouples coverage exclusions from determination whether a claim is covered on the ground that the approach may not reflect the bargain rational parties would strike if they expressly considered the matter). If the duty to defend is based upon an ambiguity in the claim, the insurer's ability to clarify the ambiguity and demonstrate that, as clarified, there is no basis for imposing a duty to defend the claim may excuse the insurer from a duty to defend.

⁵⁴ *Dobrin v. Allstate Ins. Co.*, 897 F. Supp. 442, 444 (C.D. Cal. 1995) (holding that "[a] mere statement by the complainant that he does not intend to make [a covered claim] is insufficient to establish as a matter of law that such a claim does not exist"). The court also noted that "[a]s a matter of policy . . . the insurer cannot avoid coverage simply because the complainant seeks a tactical advantage in the lawsuit." *Id.* This position is, however, of uncertain validity. The "potentiality" test is usually seen as referring to the potentiality that the claim is subject to indemnity coverage, not the potentiality that a claim potentially within coverage will be asserted. *See, e.g., Hurley Constr. Co. v. State Farm Fire & Cas. Co.*, 12 Cal. Rptr. 2d 629, 632 (Ct. App. 1992) (stating that "the insured may not speculate about

The insurer's decision whether to accept or reject the tender is also influenced by the consequences of an erroneous decision, *i.e.*, a breach of its promise to defend. In this regard, insurers will often find that the consequences of an erroneous refusal to defend, whether characterized as a breach of contract or as tortious, are quite severe. The insurer must compensate the policyholder for out-of-pocket expenses incurred by the policyholder when the policyholder assumed the defense after the insurer breached.⁵⁵ Although the policyholder's defense costs are subject to a reasonableness constraint, the policyholder is not limited to the amounts the insurer pays when it retains defense counsel for a policyholder.⁵⁶ It should quickly be observed that this result is likely to be much worse for the insurer than any costs that would probably have been incurred by the insurer in control of the defense. The policyholder is unlikely to have access to the discounted rates insurers obtain because of the volume, regularity, and nature of work they provide insurance defense firms.⁵⁷ Consequently, the costs of the defense for the policyholder are likely much higher than an equivalent defense paid for by the insurer.⁵⁸ The policyholder's liability is not capped by policy limits; thus, the policyholder may approach the defense of the case differently from the insurer. For example, the insurer acting in good faith may fund the defense at the lower end of the range of reasonableness; the policyholder may fund, or authorize funding, the defense at the upper end of the range of reasonableness. The policyholder need only incur a liability for defense costs, including attorney's fees, to create a claim for economic

unpled third-party claims to manufacture coverage"). There is a gray area between impermissible speculation and reasonable interpretation of a pled claim to determine if it contains a claim potentially within the indemnity coverage promised. *See infra* 86-87 and accompanying text.

⁵⁵ Because the insurer has contractually promised a defense, the policyholder's damages are measured by what was lost. In this case the courts do not apply the so called "American Rule" that each side is responsible for its own costs of suit insofar as the underlying litigation is concerned. *See Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 257 (1975). The "American Rule" does apply to the subsequent coverage litigation, but in this context the rule has been relaxed in many jurisdictions. *See* Eugene R. Anderson & Joshua Gold, *Recoverability of Corporate Counsel Fees in Insurance Coverage Disputes*, 20 AM. J. TRIAL ADVOC. 1, 3-5 (1996).

⁵⁶ *Amato v. Mercury Cas. Co.*, 61 Cal. Rptr. 2d 909, 913 (Ct. App. 1997) (stating that when the policyholder provides a defense after the insurer wrongfully declines to do so, the usual measure of damages is the cost of the defense).

⁵⁷ The routine nature of much personal injury litigation means that the firm can be highly leveraged. Paralegals and recent law school graduates can do much of the work at a cost to the firm substantially less than the discounted rates. Moreover, insurers are increasingly bringing defense work in house which enables them to keep a close eye on counsel costs. The propriety of these actions has begun to receive serious scrutiny. David May, Note, *Inhouse Defenders of Insureds: Some Ethical Considerations*, 46 DRAKE L. REV. 881 (1998). A recent article in the *ABA Journal* noted the increased use of in-house staff by insurance companies to provide a defense for policyholders. Debra Baker, *A Grab for the Ball*, 85 A.B.A.J. 42 (April 1999) (discussing several court challenges to the use of in-house staff as retained defense counsel).

⁵⁸ In this context, reasonable fees are usually determined by the market rate available to the policyholder, which may be greater than the actual rate paid by the policyholder. *See* JAMES FISCHER, UNDERSTANDING REMEDIES § 333(b) (1999) (noting split in authorities whether either the incurred cost of employing lawyers or the retainer agreement operate to limit the amount of recoverable fees).

damages against the insurer. Indeed, the stronger the claim of breach by the insurer, the greater the economic incentives of the policyholder and the attorney to provide an "expensive" defense and seek recoupment from the insurer.

The calculation of cost of defense damages does not present anything unique or extraordinary to this area of law. The awarding of additional damages is, however, another matter. It is here that many courts have adopted a damages approach that strongly deters insurers from declining tenders in all but the most clear cut, no coverage case.

When the insurer breaches the duty to defend by erroneously declining the tender of the defense, many jurisdictions prevent the insurer from relitigating issues resolved in the underlying litigation, such as the policyholder's liability and the claimant's damages.⁵⁹ This occurs even though, as a result of its rejection of the tender of the defense, the insurer has not controlled the defense of the claim; rather, the policyholder has controlled the defense. The primary justification for this approach is to remove any economic incentives that would encourage the insurer to reject the tender.

The breaching insurer, while not completely at the mercy of the policyholder and the claimant, is greatly restricted in any efforts to avoid a result reached in its absence. The insurer may relitigate those issues only if it can show that the underlying resolution was "unreasonable" or was a product of "fraud or collusion" between the policyholder and the claimant.⁶⁰ The underlying rationale for barring relitigation of claim liability is that the "breach" of the duty to defend serves as a surrogate for the "privity" that is created when the insurer unconditionally defends.

Second, not only is the breaching insurer precluded from relitigating the merits of the underlying claim, the insurer may be barred from litigating whether the claim is covered. As noted by the Washington Supreme Court:⁶¹

⁵⁹ JERRY, *supra* note 1, at § 111[h][5] (noting split in the decisions as to whether the breaching insurer is responsible for the policyholder's settlement of the underlying action, but concluding that barring the insurer from contesting the merits or the value of the underlying claim is the better approach). It should be observed that barring the insurer from contesting coverage and barring the insurer from invoking policy limits are distinct and different issues even though both are often found in the breach of defense cases. *Id.* at § 111[h][6] (discussing whether breaching insurer should be barred from contesting that the settled claim is covered).

⁶⁰ *Cambridge Mut. Fire Ins. Co. v. Perry*, 692 A.2d 1388, 1391-92 (Me. 1997):

The insured's right to indemnification for a settlement entered into following an insurer's wrongful refusal to defend, however, is not without limitation. An insurer is liable only if the settlement amount is reasonable and is made in good faith. Such a settlement reached by the insured is presumptively reasonable, however, and the insurer has the burden of proving that the settlement is unreasonable or in bad faith.

Id. at 1391 (citations omitted); *see also* *Cont'l Cas. Co. v. Westerfield*, 961 F. Supp. 1502, 1509-10 (D.N.M. 1997) (holding that under New Mexico law a finding that the underlying settlement was preclusive does not excuse the insurer's indemnity obligations; the finding does, however, strip the settlement of its preclusive effect against the insurer); *Carlson v. Zellaha*, 482 N.W.2d 281, 283 (Neb. 1992). The relationship between unreasonableness and collusion has proved difficult to resolve. *Xebec Dev. Partners, Ltd. v. Nat'l Union Fire Ins. Co.*, 15 Cal. Rptr. 2d 726, 749-60 (Ct. App. 1993); *Wolff v. Royal Ins. Co.*, 472 N.W.2d 233, 236 (S.D. 1991).

⁶¹ *Kirk v. Mt. Airy Ins. Co.*, 951 P.2d 1124 (Wash. 1998).

When the insurer breaches the duty to defend in bad faith, the insurer should be held liable not only in contract for the cost of the defense, but also should be estopped from asserting the claim is outside the scope of the contract and, accordingly, that there is no coverage. The coverage by estoppel remedy creates a strong incentive for the insurer to act in good faith, and protects the insured against the insurer's bad faith conduct

Without coverage by estoppel and the corresponding potential liability, an insurer would never choose to defend with a reservation of rights when a complete failure to defend, even in bad faith, has no greater economic consequence than if such refusal were in good faith. The requirement of acting in good faith cannot be rendered meaningless.⁶²

If the claim, as resolved by the policyholder, is covered, the insurer usually must pay the claim up to policy limits. In some jurisdictions, the breaching insurer's liability is extracontractual and may exceed policy limits.⁶³ The reason for barring litigation over the carrier's indemnity obligation is that the breach of the duty to defend serves as a surrogate for the estoppel that arises when the insurer unconditionally defends.⁶⁴

The insurer which breaches its duty to defend thus sustains two significant legal consequences from its actions. The first consequence is that the insurer loses control of the defense to the policyholder. A corollary to this is that the policyholder is freed of its contractual obligation to cooperate and assist the

⁶² *Id.* at 1128 (citation omitted).

⁶³ *Amato v. Mercury Cas. Co.*, 61 Cal. Rptr. 2d 909, 913-14 (Ct. App. 1997) (holding that when the insurer tortiously breaches duty to defend and as a consequence the policyholder suffers an adverse judgment, the insurer is liable for the entire judgment even if the claim is not covered under the policy); *Conway v. Country Cas. Ins. Co.*, 442 N.E.2d 245, 249 (Ill. 1982) (same). Many jurisdictions, however, limit the insurer's liability. Under this approach, if the insurer breaches the duty to defend by refusing to accept a valid tender, the insurer assumes responsibility for the insured's litigation costs and is normally required to indemnify the insured for a settlement of the underlying claim up to the policy limit. *See Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 536 F.2d 730, 736 (7th Cir. 1976) ("[L]iability for failure to defend is ordinarily limited to the amount of the policy plus attorneys' fees and costs."); *Engeldinger v. State Auto. & Cas. Underwriters*, 236 N.W.2d 596, 601 (Minn. 1975) (re-affirming the rule that an insurer is liable up to only the "maximum policy coverage" and is not liable for the entire verdict even in cases of bad faith). The rationale appears to be that while the breaching insurer should not be in a better position than the non-breaching insurer, *see infra* note 74 and accompanying text, neither should the breaching insurer be in a worse position than the non-breaching insurer else the policyholder would be better served by breach than performance. *Cf. Mesmer v. Md. Auto. Ins. Fund*, 725 A.2d 1053, 1065 (Md. 1999) (holding that extracontractual damages are limited to "bad faith" failure to settle claims against insurers that have assumed control of the defense; because the insurer that wrongfully refuses to defend does not control the defense, no "bad faith" claim for breach of duty to defend is possible).

⁶⁴ Most jurisdictions rely on principles of estoppel to bind the breaching insurer to the extracontractual damages, but some jurisdictions rely on principles of proximate cause. Some courts permit relitigation even when the insurer breaches its duty to defend. *See N.W. Pump & Equip. Co. v. Am. States Ins. Co.*, 925 P.2d 1241 (Or. Ct. App. 1996) (rejecting arguments that insurer which breached duty to defend may not contest indemnity coverage); *Sentinel Ins. Co., Ltd. v. First Ins. Co. of Hawaii, Ltd.*, 875 P.2d 894, 912-13 (Haw. 1994) (holding that blanket application of coverage by waiver or estoppel, when insurer breaches duty to defend, subverts any meaningful distinction between the duty to defend and the duty to indemnify and serves no purpose other than to punish the insurer for breach of its contractual duty) (collecting decisions).

insurer and not settle without the insurer's consent.⁶⁵ The policyholder is given substantial leeway to conduct the defense to extricate itself from the position it finds itself in due to the insurer's breach. Principles of "good faith and fair dealing" and "mitigation of damages" would suggest a general obligation to act reasonably and prudently; however, courts have not attempted to equalize the duties of the policyholder in control of the defense because of insurer-breach to the duties of the insurer in control of the defense and because of unconditional acceptance of the tender.⁶⁶ To see this, one need only compare the significant scrutiny that attaches to insurer settlement conduct with the corresponding lax scrutiny of policyholder settlement conduct.⁶⁷ Even adjusting so that we compare situations when the insurer's settlement conduct is evaluated against a backdrop of policyholder breach of contractual duty, one finds the insurer's settlement conduct is strictly scrutinized, whereas policyholder settlement conduct receives perfunctory scrutiny.⁶⁸

⁶⁵ *Maneikis v. St. Paul Ins. Co. of Ill.*, 655 F.2d 818, 822 (7th Cir. 1981) (holding that the "insurer has no right to insist that the insured be bound by the provisions of the insurance contract inuring to its benefit, . . . when it has already breached the contract by violating the provisions inuring to the benefit of the insured"); *Sims v. Ill. Nat'l Cas. Co.*, 193 N.E.2d 123, 129 (Ill. App. Ct. 1963), *quoted in Eigner v. Worthington*, 66 Cal. Rptr. 2d 808, 813 (Ct. App. 1997) (noting that "[w]hen an insurer wrongfully refuses to defend, the insured is relieved of [the] obligation to allow the insurer to manage the litigation and may proceed in whatever manner is deemed appropriate") (citations omitted).

⁶⁶ *See McNicholes v. Subotnik*, 12 F.3d 105 (8th Cir. 1993):

We turn next to St. Paul's contention that the settlement agreement is the product of fraud and collusion because Subotnik received several side benefits from the agreement and because the amount agreed upon was not reasonable and prudent. St. Paul's argument confuses the issue of fraud and collusion with the separate issue of reasonable and prudent settlement. The settlement agreement is not the product of fraud and collusion simply because St. Paul believes that the amount agreed upon is not reasonable and prudent.

Id. at 109.

⁶⁷ Most jurisdictions have rejected attempts by insurers to impose affirmative obligations of good faith and fair dealing on policyholders. *See, e.g.*, *First Bank of Turley v. Fid. & Deposit Ins. Co. of Md.*, 928 P.2d 298, 307-08 (Okla. 1996) (holding that liability insurer has no cause of action for reverse bad faith by policyholder); *Johnson v. Farm Bureau Mut. Ins. Co.*, 533 N.W.2d 203, 207-08 (Iowa 1995) (same). More importantly, some courts have expressly permitted the policyholder to consider its own interests when evaluating settlement offers from the claimant. *See, e.g.*, *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980) (refusing to excuse excess insurer's duty to indemnify when policyholder rejected settlement offer which would have limited recovery to lower layers of coverage). *Compare Kaiser Found. Hosp. v. N. Star Reinsurance Corp.*, 153 Cal. Rptr. 678 (Ct. App. 1979) (holding that policyholder, which colluded with primary insurer to allocate losses so as to reduce primary's exposure while increasing excess insurer's exposure, breached duty owed to excess insurer). *Kaiser Foundation Hospitals* and *Safeway Stores* suggest that when the policyholder is in control of the defense, the policyholder cannot seek to increase the insurer's obligations and decrease its own obligations by falsifying the record; however, the policyholder can be a risk taker in a way the insurer cannot when the insurer is in control of the defense.

⁶⁸ *See supra* notes 59-60 and accompanying text (noting that a settlement by the policyholder after the insurer has breached its duty to defend is deemed presumptively reasonable). The courts do tend, however, to recognize a duty on the part of the policyholder to conduct itself after the insurer's breach in a manner that would mitigate damages. *See, e.g.*, *Rhone-Poulenc Basic Chem. Co. v. Am. Motorists Ins. Co.*, 616 A.2d 1192, 1196-98 (Del. 1992) (holding that mitigation provision in insurance contract clearly and unambiguously imposed a duty to mitigate on policyholders to prevent further environmental contamination, but not

The second consequence for the insurer which breaches its duty to defend is that it is bound by the resolution secured by the policyholder in control of the defense as if the insurer were in control. Considerations that could have been legitimately ignored by the insurer in its settlement decision-making may significantly influence the policyholder toward settling the claim at the high range of reasonableness or beyond.⁶⁹

The strategic interests of the claimant and the policyholder may change so that rather than acting as adversaries, each may find it in its own interest to quantify the loss and attempt to shift responsibility to the insurer. Thus, the claimant and policyholder may agree to compromise the dispute. In exchange for policyholder concessions regarding the value of the claim, the claimant may agree to look primarily or exclusively to the insurer for satisfaction of the claim.⁷⁰ This resolution can be achieved in a number of ways, the most common being a settlement, stipulated judgment, a default judgment, or a "no defense" trial.⁷¹ In each of these cases, the claimant will agree not to seek

to repair or restore damage that had already occurred, and that the required mitigation costs were not covered expenses under the policy). The court stated in *dicta*, however, that a similar result would be reached even in the absence of an express mitigation requirement:

Public policy clearly favors imposing upon insureds a duty to mitigate damages. In the absence of such a rule, insureds could sit back and allow environmental damage to accumulate until they are compelled to mitigate damages through litigation. The provision at issue here is consistent with that policy.

Id. at 1197; *see also* Real Asset Mgmt. Inc. v. Lloyds of London, 61 F.3d 1223, 1229-30 (5th Cir. 1995) (stating that under Louisiana law a plaintiff has a duty to mitigate damages and the duty is not excused by the insurer's breach of the duty to defend); Boeing Co. v. Aetna Cas. & Sur. Co., 784 P.2d 507, 516 (Wash. 1990); Aerojet-Gen. Corp. v. San Mateo County Superior Court, 257 Cal. Rptr. 621, 635 (Ct. App. 1989); *but see* Heller v. The Equitable Life Assurance Soc'y of the United States, 833 F.2d 1253, 1258 (7th Cir. 1987) (refusing to impose, in the absence of a clear, unequivocal, and specific contractual requirement, that the policyholder submit to surgery to attempt to minimize his disability).

⁶⁹ The policyholder's reputation interest, which the insurer may disregard, *see supra* note 15, in effecting settlement decisions may loom large when the policyholder is in control of the defense. *See supra* notes 19-20 and accompanying text (noting that rational policyholder may be less protective of insurer's interests than insurer would be).

⁷⁰ Even if the policyholder must mitigate its losses, *supra* note 68, mitigation does not necessarily require that the policyholder maintain an aggressive defense. The policyholder need only do what is reasonable given the resources available. *See supra* note 60. The fact that a different course of conduct would, with the benefit of hindsight, have been more effective is not determinative. *See* Amato v. Mercury Cas. Co., 61 Cal. Rptr. 2d 909, 913-14 (Ct. App. 1997).

⁷¹ This approach, while commonplace, is not without risk to the parties to the "agreement." *Steil v. Fla. Physician's Ins. Reciprocal*, 448 So. 2d 589, 592 (Fla. Ct. App. 1984) (stating that settlement figure is more suspect when policyholder receives covenant not to execute and thus bears no financial liability for settlement). There is less insistence in "breach" cases that the policyholder obtain an adjudication of liability from a third-party neutral, such as a court or jury, than in cases when the insurer has not rejected its defense obligation but is presented with a compromise engineered by the claimant and the policyholder. *See* State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696, 714-15 (Tex. 1996):

[W]e hold that a defendant's assignment of his claims against his insurer to a plaintiff is invalid if (1) it is made prior to an adjudication of plaintiff's claim against defendant in a fully adversarial trial, (2) defendant's insurer has tendered a defense, and (3) either (a) defendant's insurer has accepted coverage, or (b) defendant's insurer has made a good faith effort to adjudicate coverage issues prior to the adjudication of plaintiff's claim. We do not address whether an

enforcement of the award against the policyholder, but look solely to the insurer for satisfaction. Because the posture of the case is that the insurer breached, courts frequently limit insurer attacks on these forms of dispute resolution to a showing that the resolution achieved between the claimant and the policyholder was unreasonable, collusive, or fraudulent.⁷²

The consequences of breaching the duty to defend are so severe and the tests for triggering the duty to defend are so broad, that the insurer assumes substantial risks when it declines a tender because of its belief that the claim is not covered. The decisional law strongly encourages insurers to assume the defense of their policyholders even in cases in which the policyholder's right to a defense is marginal at best.⁷³

It may be contended that it is unfair to hold even a breaching insurer to a result reached in its absence. Moreover, in the litigation the insurer is "represented" by a party, the policyholder, who in the aftermath of the declination of the defense may no longer share common litigation interests with the insurer. In the "no breach" cases, insurer's unconditional acceptance and control of the defense are the central premise of the arguments that bind the insurer to the results reached and prevent it from raising coverage defenses. The absence of acceptance and control would seem, at the minimum, to permit the insurer to litigate the issue of coverage. The decisional law is, however, generally to the contrary.

Courts have barred the breaching insurer from litigating issues involving either the underlying claim or coverage not only to encourage insurers to accept tenders, but also under the rationale that a breaching insurer should not be in a better position than an insurer that accepts the tender.⁷⁴ The benefits derived from controlling the defense are immediate and the risks associated with rejection of the tender of the defense are great. In jurisdictions creating an estoppel out of "breach," a cautious insurer would reject a tender only when the decisional law has established that the claim is not covered.⁷⁵ If insurers could

assignment is also invalid if one or more of these elements is lacking. In no event, however, is a judgment for plaintiff against defendant, rendered without a fully adversarial trial, binding on defendant's insurer or admissible as evidence of damages in an action against defendant's insurer by plaintiff as defendant's assignee.

⁷² See *supra* note 60.

⁷³ Fischer, *supra* note 1 (suggesting that the approach was deliberate, not accidental). Decisions, such as *Kirk*, discussed at notes 61-62 and accompanying text, support the "encouragement" theory.

⁷⁴ *Geddes & Smith v. St. Paul Mercury Indem. Co.*, 334 P.2d 881, 883 (Cal. 1959). Approximately twenty-six states recognize estoppel theory as barring the insurer which breaches its duty to defend from contesting indemnity coverage. See *supra* note 40.

⁷⁵ Professor Abraham explored why the insurer would breach the duty to defend under the assumption that the liability costs for nonperformance in doubtful cases are greater than performance costs in doubtful cases. KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE LEGAL THEORY AND PUBLIC POLICY* 195-96 (1986). Professor Abraham noted that breach was often caused by uncertainty:

Nevertheless, the duty to defend sometimes is breached. As in the case of settlement of suits against the insured, however, the reason generally is not subjective bad faith, but contractually unregulated discretion. The problem is that policies provide for a duty to defend whenever a judgment against the insured in the suit in question would be payable under the policy. But if at the outset of a suit against the insured the ultimate coverage responsibility of the insurer under

decline tenders and preserve the ability to litigate coverage, we would likely see an increase in such conduct.⁷⁶ When insurers are barred from litigating coverage issues if they erroneously reject the tender, this sanction will serve as an incentive for insurers to accept tenders in marginal cases.⁷⁷ The duty to defend cases have been marked by a consistent judicial theme of encouraging insurers to accept tenders and provide defenses for their policyholders. Courts have manifested a preference that coverage issues be litigated, if at all, separate from the defense of the claim and, most importantly, that the policyholder not be forced to bear the costs of defense while awaiting a judicial declaration whether a defense is owed. Rather, it is the insurer, encouraged by draconian sanctions for erroneous rejections, who must bear the costs of defense until judicially relieved of the obligation or until the insurer can resolve the claim in a manner that permits it to terminate properly its defense obligation to the policyholder.⁷⁸

The insurer-breach case exhibits several features that should serve to limit it as a model for non-breach cases.⁷⁹ First, in the breach case the policyholder has lost what it specifically contracted for, a defense paid for by the insurer. Second, the policyholder has lost the benefit of the insurer's experience and

the policy is uncertain, then it is also unclear whether the duty to defend has been triggered. The language of the standard liability policy provides almost no guidance.

Id. at 196 (footnote omitted).

⁷⁶ *Kirk v. Mt. Airy Ins. Co.*, 951 P.2d 1124 (Wash. 1998).

⁷⁷ The insurer can, of course, litigate whether there was a duty to defend. Often this inquiry includes a coverage determination. However, the burden of proof is different in the defense context from the indemnity context. For purposes of the duty to defend it is sufficient for the policyholder to show that the claim *as pleaded* is within, or potentially within, the coverage promised by the policy. For purposes of indemnification, the policyholder must show that *in fact as adjudicated* the claim is within coverage. Whether a duty to defend exists is determined based on facts actually and constructively known by the insurer. To avoid a defense obligation the insurer may have to show that no duty to defend exists as a matter of law. *Haskel, Inc. v. Superior Court*, 39 Cal. Rptr. 2d 520, 527 (Ct. App. 1995). The ability of an insurer to obtain a declaratory coverage determination is discussed by Pryor, *supra* note 36, at 21-48.

⁷⁸ The duty to defend may be terminated by payment of policy limits in settlement of claims or judgments against the policyholder, *Am. States Ins. Co. of Tex. v. Arnold*, 930 S.W.2d 196, 203 (Tex. Ct. App. 1996), by declaratory relief demonstrating that, as a matter of law, there is no potential for liability, *Montrose Chem. Corp. v. Superior Court*, 861 P.2d 1153, 1160 (Cal. 1993), or by amendment of the suit by the claimant, eliminating all claims on which a duty to defend may be based. *See Reser v. State Farm*, 981 S.W.2d 260, 263-64 (Tex. Civ. App. 1998). These examples are not exhaustive of the methods by which the duty to defend may be terminated, nor are they without exception. *Cf. Nationwide Ins. Co. v. Hunley*, 915 F.2d 557, 558 n.1 (9th Cir. 1990) (noting that it is unresolved under California law whether payment of policy limits on behalf of named insured excuses insurer from duty to defend additional insured).

⁷⁹ A policyholder may wrongfully obtain control of the right to settle. *Safeco Ins. Co. of Am. v. Superior Court*, 84 Cal. Rptr. 2d 43, 45-48 (Ct. App. 1999) (holding that settlement entered into between policyholder and claimant was not enforceable against insurer which had assumed control of the defense and had not consented to settlement). What constitutes the "wrongful" assumption of the right to settle varies. *United Servs. Auto. Ass'n v. Morris*, 741 P.2d 246 (Ariz. 1987) (permitting policyholder to enter into reasonable settlement with the claimant when the conditionally defending insurer unreasonably rejects a "within limits" settlement offer and thus exposes the policyholder to personal liability in excess of policy limits).

expertise as a repeat player within the civil justice system.⁸⁰ Lastly, there is the difficulty in measuring the full consequences of the breach. Was the loss "caused by" the breach or by the conduct of the defense by the policyholder? Should the policyholder's conduct of the defense be held to the same standard as the insurer's conduct of the defense would have been if the insurer had not breached but defended? Would the result have been different if the insurer had conducted the defense? Generally, courts have given only slight attention to these issues; they have tended instead to focus on the fact of insurer breach as disqualifying the insurer from complaining too loudly, or too much, about developments subsequent to the breach. Doubts are resolved against the insurer because the insurer is the party in breach and the insurer's breach created the uncertainty.⁸¹

It is important to place this problem within the context of the values the duty to defend has come to symbolize for policyholders and the benefits that the legal system accrues when insurers, with their financial resources, become involved in the dispute resolution process.⁸² Settling claims and compensating claimants are recurring themes in dispute resolution and insurance law. We should not be surprised that the synergistic force of the two concepts would help drive a doctrine that discourages insurer rejection of tenders and, correspondingly, encourages insurer participation in the defense of the claim.

IV. THE NON-STANDARD CASE: CONFLICT OF INTEREST BETWEEN THE INSURER AND THE POLICYHOLDER

In the standard case, the insurer makes an unconditional acceptance of the tender of the defense and thereby binds itself to the fortunes of the policyholder. Insurers are strongly encouraged by draconian legal sanctions to accept tenders in all but the clearest cases of non-coverage. The insurer's duty to defend is based on the claim as alleged. The insurer's duty to indemnify the policyholder is based on the claim as adjudicated or resolved.⁸³ As a conse-

⁸⁰ See *supra* note 17.

⁸¹ This is analogous to the rule in damages quantification that a defendant who has caused a loss will not be heard to complain about a plaintiff's incomplete damages proof when the defendant has by its actions made it difficult for the plaintiff to substantiate its proof. *Bigelow v. RKO Radio Pictures*, 327 U.S. 251, 265 (1946). The principle has early common law roots. See *Armory v. Delamirie*, 93 Eng. Rep. 664 (1722). In *Amato v. Mercury Casualty Co.*, 61 Cal. Rptr. 2d 909, 917-18 (Ct. App. 1997), the court rejected the contention that the policyholder must establish that the insurer's refusal to defend resulted in a larger award against the policyholder than would have occurred if the insurer had not breached the duty to defend.

⁸² See Samuel R. Gross & Kent D. Syverud, *Don't Try: Civil Jury Verdicts in a System Geared to Settlement*, 44 UCLA L. REV. 1, 2-3 (1996) (noting that our legal system "prefers settlements" and that we "have designed a system of civil justice that embodies and expresses that preference in everything from the rules of procedure and evidence, to appellate opinions, to legal scholarship, to the daily work of our trial judges") (footnotes omitted).

⁸³ *Reser v. State Farm*, 981 S.W.2d 260, 263 (Tex. Civ. App. 1998):

[T]he duty to defend and the duty to indemnify are two "distinct and separate duties." Generally, the factual allegations in the petition and the policy language trigger the duty to defend. This duty is unaffected by facts ascertained before suit, developed in trial, or by the ultimate outcome of the case. Unlike the duty to defend, the duty to indemnify only arises after an insured has

quence of the broader duty to defend test, insurers accept tenders for the defense of many claims as to which no duty to indemnify may exist.

If the universe of the insurer's potential responses to a tender was either to accept unconditionally or decline, the insurer would be required to make a significant coverage decision, having long-term implications, early in the dispute resolution process before the insurer had the opportunity to conduct an investigation of the facts. The insurer's promises are not, however, open-ended. The promise of indemnification is conditioned on the claim being within the scope of coverage promised. The duty to defend cannot be completely decoupled from the duty to indemnify without rewriting the bargain entered into between the policyholder and insurer. A promise to defend claims within coverage is different from a promise to defend any claim. No standard form insurance contract purports to promise to defend the policyholder against any claim.

If the insurer were presented with only an "either-or" choice, this might call into greater question the propriety of imposing draconian sanctions on the insurer which erroneously declined a tender.⁸⁴ Thus, it is not surprising that a middle ground has been created, nor is it surprising that courts have emphasized the existence of the middle ground alternative when affirming the use of draconian sanctions against an insurer that erroneously declined a tender of the defense and failed to take advantage of the middle ground option.

The middle ground that courts have recognized is the conditional defense. A conditional defense exploits the differences between the legal tests that distinguish the insurer's duty to defend from its duty to indemnify. Under a conditional defense, the insurer accepts the tender and agrees to provide a defense for the policyholder, but the insurer reserves the right to contest that the insurer has obligations to indemnify the policyholder.⁸⁵ This may be accomplished bilaterally through the acceptance by the policyholder of a "no waiver" agreement. Alternatively, the insurer may impose the conditional defense unilaterally through a reservation of rights letter. The effect of each approach is to permit the insurer to assume the defense of the claim against the policyholder without waiving, surrendering, or losing the right to contend that the claim is not subject to indemnity under the policy. For example, the claim may be that

been adjudicated, whether by judgment or settlement, to be legally responsible for damages in a lawsuit.

(citations omitted).

⁸⁴ See *supra* notes 35-38 and accompanying text. In *Liquor Liab. Joint Underwriting Assoc. of Mass. v. Hermitage Ins. Co.*, 644 N.E.2d 964 (Mass. 1995), the insurer declined the tender of an assault and battery claim based on an assault and battery exclusion. The court held that the duty to defend nevertheless attached because the policyholder's liability was alleged to also lie in its negligence in serving alcohol to the patron who committed the assaults. The court rejected authorities that had held the exclusion was encompassing of negligent failure to do something. *Id.* at 967-68. The consequence was that the insurer was deemed liable for the entire settlement because it was unable to establish an allocation between the damages based on the covered and the non-covered theories of recovery proposed by the claimant. *Id.* at 968-69.

⁸⁵ See, e.g., *First Gen. Realty Corp. v. Md. Cas. Co.*, 981 S.W.2d 495, 501 (Tex. Civ. App. 1998) (noting that insurer's offer of a conditional defense does not constitute a refusal to defend). The insurer will be permitted a reasonable period of time to conduct an investigation and analyze the claim in order to make a coverage decision. *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 71 Cal. Rptr. 2d 882, 889-90 (Ct. App. 1998).

the policyholder battered the claimant. Battery may be excluded from coverage under the policy, but the claim may be factually susceptible to a construction and ultimate resolution as involving injury due to negligence, a covered claim under standard liability coverage.⁸⁶ As so construed, the insurer would have a duty to defend.⁸⁷ However, if the insurer accepted the tender unconditionally and if the claim were sustained, the insurer might have to indemnify the policyholder for a claim the insurer intended to exclude from coverage. If the claim resulted in a general verdict for the plaintiff, it would be difficult for the insurer in control of the defense to contend that the verdict was based on battery (the excluded event) rather than negligence (the covered event). The more the insurer conducted itself, through its control of defense counsel, to ensure that any resulting plaintiff's verdict rested on an excluded event rather than a covered event, the more susceptible the insurer is to a subsequent suit charging "bad faith" arising out of its manipulation of its right to defend so as to prejudice the policyholder.⁸⁸ The conditional defense permits the insurer to defend and contend that any resulting judgment is not covered because it falls within the battery exclusion.⁸⁹ In the coverage litigation, neither the insurer nor the policyholder will be bound by the prior determination that the loss was caused by the excluded event (battery) or by the included event (negligence). In the coverage litigation, both the insurer and the policyholder may seek to establish a favorable coverage position. While the policyholder's liability to the plaintiff is not subject to relitigation because the insurer's control placed it in privity with the policyholder, whether that liability is covered, *i.e.* is a "debt" owed by the insurer to the policyholder, is open to litigation in the coverage action.

⁸⁶ The duty to defend is based on an analysis of the *facts* alleged in the claim. Even if the legal theory asserted is not covered, a duty to defend may exist if the *facts* complained of support a covered legal theory. *See, e.g.,* *Employers Mut. Cas. Co. v. Cedar Rapids Television Co.*, 552 N.W.2d 639, 643-44 (Iowa 1996) (holding that the dismissal of the sole covered claim (malicious prosecution) in a multi-claim complaint did not terminate the insurer's duty to defend; factual allegations contained in the joined intentional infliction of emotional distress claim *could* support a malicious prosecution claim notwithstanding the previous dismissal).

⁸⁷ *See, e.g.,* *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966) (finding that altercation between policyholder and motorist was susceptible to construction of negligent self-defense and thus potentially within coverage promise by liability insurance policy); *Liquor Liab. Joint Underwriting Assoc.*, 644 N.E.2d at 964.

⁸⁸ The policyholder's vulnerability to the insurer's exercises of its contract rights has been a central feature of the judicial creation of the duty of good faith and fair dealing. Good faith in this context essentially means that the insurer may not exercise its contract rights in a manner unreasonably harmful to the policyholder when the burden of the insurer's exercise of its rights rests on the policyholder.

⁸⁹ Many jurisdictions today permit the insurer to impose a conditional defense unilaterally through a "reservation of rights" letter. *First Gen. Realty Corp.*, 981 S.W.2d at 501. There is some disagreement as to the prevailing rule. *Compare* *Walbrook Ins. Co. v. Goshgarian & Goshgarian*, 726 F. Supp. 777, 783 (C.D. Cal. 1989) (surveying case law and concluding that "the modern trend is to find a unilateral reservation to be effective without the insured's consent"); *with* 7 C JOHN APPLEMAN, *INSURANCE LAW & PRACTICE* §§ 4686, 4694 (Berdal ed. 1979) (concluding that a majority of courts permits policyholder to reject conditional defense and require the insurer to elect between an unconditional defense or rejection of the tender).

The conditional defense encourages insurers to accept tenders from their policyholders and provides an intermediate ground between the costs of an unconditional acceptance of the tender and the perils of a declination of the tender. The middle ground, however, brings to the forefront a new player to the policyholder-insurer relationship: "conflict of interest." Unlike the "unconditional defense" model where the insurer is tightly bound to the fortunes of the policyholder, under the conditional defense the interests of the policyholder and the insurer are in conflict as to the issue of indemnity coverage for the claim. That is not to say that conflicts of interest are alien to the unconditional defense situation. The insurer may decide to fund a very limited defense or gamble for a defense verdict because of low policy limits relative to the claim's expected value.⁹⁰ These conflicts do not, however, turn on coverage; rather, they are strategic.⁹¹ In the conditional defense context, the concern is that the insurer may use its control of the defense to influence the determination of the coverage issue.

Consider, for example, the previous hypothetical involving a claim for battery. Because the insurer controls the defense, the insurer could, through its direction of defense counsel, attempt to shift liability to non-covered claims. In other words, if a fact finder resolved that the policyholder was liable to the claimant, the fact finder could be induced to do so on the basis of battery (an event excluded from coverage) rather than negligence (an event included within coverage). The insurer could then decline to pay indemnity for the claim based on that finding. This is the negative consequence of permitting the insurer to provide a conditional defense. The fear is that the insurer will use its resources and position to achieve a conclusion that saddles the policyholder with a judgment for which there is no right of indemnity. By creating a mechanism that preserves the insurer's ability to contest that an adjudicated claim is within

⁹⁰ *Betts v. Allstate Ins. Co.*, 201 Cal. Rptr. 528 (Ct. App. 1984) (holding that the insurer breached its duty to the policyholder to effect a settlement within policy limits when the insurer proceeded to trial notwithstanding liability estimates strongly against its policyholder and then advised policyholder to file for bankruptcy to secure the discharge of the excess policy limits portion of adverse judgment). The line between a disqualifying and non-disqualifying conflict may at times be difficult to find. This has proven particularly to be the case when the "conflict" involves the policyholder's exposure to an excess verdict. *See, e.g.*, *Hartford Acc. & Indem. Co. v. Foster*, 528 So. 2d 255, 272-73 (Miss. 1988) (finding that interests of the insurer and the policyholder "conflict" if an actual exposure to an excess policy limits judgment exists and an opportunity to settle within limits exists); *but see* CAL. CIV. CODE § 2860(b) (West 1993) (stating that "[n]o conflict of interest shall . . . be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits").

⁹¹ A distinction is usually drawn between coverage conflicts and strategic conflicts. Coverage conflicts usually require that the insurer surrender its contractual rights to control the defense. Strategic conflicts are less likely to be understood as depriving the insurer of its contractual right to control the defense. *Mut. Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365 (Minn. Ct. App. 1991) (discussing different judicial responses to what constitutes a conflict disqualifying the insurer from controlling the defense); *see generally* William T. Barker, *When Does the Insurer Lose the Right to Control the Defense?* 58 DEF. COUNS. J. 469 (1991) (discussing situations which create a conflict of interest such as to deprive the insurer of its contractual right to control the defense). Strategic conflicts usually come to light only if they cause actual harm to the policyholder, *i.e.*, cause the insurer to reject a within limits settlement offer resulting in an excess of policy limits judgment.

coverage, *i.e.*, that a general verdict for the plaintiff actually involved an excluded claim such as assault and battery, the law creates an opportunity for abuse. Here, that opportunity presents itself in the option that the insurer would conduct the defense so that the jury's verdict would rest solely on an excluded claim, *i.e.*, assault and battery. Even though the result would not be binding on the policyholder, because it was the product of a conflict of interest, the policyholder would be burdened with (1) the judgment, (2) the insurer's refusal to pay, and (3) the obligation to litigate further to secure a coverage determination.

Courts and commentators have disagreed as to the exact contexts under which a conditional defense creates a conflict of interest between the insurer and the policyholder sufficient to disqualify insurers from controlling the defense. It is not necessary to canvass that debate for I am interested here in how courts respond to the problem posed by a conditional defense and the consequences their solution has engendered in the context of settlement funding.

One approach to the problem of conflict of interest is to deprive the insurer of its *power* to control the defense but not its *duty* to provide a defense. Just as the ability to maintain a conditional defense exploited the differences between the duty to defend and the duty to indemnify, this approach to the "conflict of interest" problem exploits the perceived differences between "providing" a defense and "controlling" that defense.⁹²

I use the word "perceived" deliberately. Originally "providing" a defense and "controlling" the defense were seen as intertwined.⁹³ The defense was provided not for the policyholder's benefit, but for the insurer's. The bifurcation of "providing a defense" from "controlling the defense," which was developed in the conflict of interest cases, represented a profound change in the way courts looked at the duty to defend. The duty to defend was no longer subservient to the duty to indemnify, but became independent of, and in some ways more valuable than, the duty to indemnify. The "conflict of interest" cases followed naturally from the emergence of the defense obligation as a separate, personal right of the policyholder. Liability insurance now was seen as not only including the obligation to indemnify against adverse judgments on claims within coverage, but as also including a duty to protect the policyholder against the cost of litigation whenever a covered claim was "involved." As a

⁹² Two other approaches have been identified. One approach treats the "conflict of interest" as excusing the insurer's duty to provide a defense. *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7 (N.J. 1970) (holding that when a dispute between the insurer and the policyholder over coverage would be exacerbated by a party's control of the defense, the insurer's duty to defend or pay for defense was excused until existence of the duty was clarified). The New Jersey Supreme Court has, however, indicated a willingness to reconsider the *Burd* rule in *Trustees of Princeton Univ. v. Aetna Cas. & Sur. Co.*, 680 A.2d 783 (N.J. Ct. App. 1996), *rev. granted*, 688 A.2d 1050 (N.J. 1997). Another approach allows the insurer to continue to control the defense but subjects the insurer to greater scrutiny in the handling of the defense. *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133, 1135 (Wash. 1986).

⁹³ James Fischer, *Broadening The Insurer's Duty to Defend: How Gray v. Zurich Insurance Co. Transformed Liability Insurance Into Litigation Insurance*, 25 U.C. DAVIS L. REV. 141 (1991).

result of this bifurcation, control over the defense had value not only to the insurer but also to the policyholder.⁹⁴

The main response to the convergence of "conflict of interest" and "control of the defense" was to transfer control of the defense to the policyholder but to keep the other features of the duty to defend with the insurer. A "conflict of interest" did not affect the insurer's duties to investigate the claim,⁹⁵ to settle the claim,⁹⁶ or to pay for the defense. The "conflict of interest," however, may affect who controls the defense, *i.e.*, who will select counsel to defend the claim and instruct counsel regarding that defense.⁹⁷

⁹⁴ See *Safeco Ins. Co. v. Ellinghouse*, 725 P.2d 217, 221 (Mont. 1986); 14 COUCH INSURANCE § 51.85 (2d ed. 1985); *cf. In re United Indus. Serv., Inc.*, 85 F.3d 617 (Table) (4th Cir. Apr. 17, 1996) (stating that loss of right to jury trial by law firm retained by the insurer assuming control of defense constituted sufficient prejudice to estop the insurer from contesting coverage even though the policy by its terms did not provide coverage); see also *Bluestein & Sander v. Chicago Ins. Co.*, 276 F.3d 119 (2nd Cir. 2002) (holding that unreasonable delays in disclaiming coverage are estopped because insured sustained prejudice from intervening loss of control of defense).

⁹⁵ *Hyatt Corp. v. Occidental Fire & Cas. Co.*, 801 S.W.2d 382, 388-89 (Mo. Ct. App. 1990) (noting that the insurer has duty to consider offers of settlement within policy limits regardless of whether the insurer actually undertakes the defense). Whether the duty to investigate has itself been triggered is a different matter. *Paulfrey v. Blue Chip Stamps*, 197 Cal. Rptr. 501, 508 (Ct. App. 1983) (holding that the policyholder must comply with claim and notice requirements before the insurer's duty to investigate the claim is triggered); *cf. Colonial Oil Indus., Inc. v. Underwriters Subscribing to Policy Nos. T0315046 & T031504671*, 491 S.E.2d 337 (Ga. 1997) (holding that when the claim on its face showed no coverage, the duty to investigate did not attach until the policyholder apprised the insurer of facts sufficient to trigger the duty to defend).

⁹⁶ While the insurer that provides a conditional defense but loses control of the defense may not be collaterally estopped from contesting coverage issues, see *Am. Cas. Co. v. Corum*, 885 P.2d 726, 728 (Or. App. 1994), *vacated on other grounds*, 894 P.2d 461 (Or. 1995), the insurer may have a continuing obligation to attempt to effect a settlement of the claims. *Cf. W. Polymer Tech. Inc. v. Reliance Ins. Co.*, 38 Cal. Rptr. 2d 78, 81-82 (Ct. App. 1995) (stating that the policyholder's right to independent counsel did not divest the insurer of its right to settle the claim as the insurer deemed expedient). The right to settle is, of course, distinct from the duty to settle. See *supra* note 42.

⁹⁷ Several approaches to the issue have been recognized. The majority approach appears to be that when there is a disqualifying conflict, the right to select defense counsel is vested solely in the policyholder. See, *e.g.*, *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810, 815 (N.Y. 1981); *Md. Cas. Co. v. Peppers*, 355 N.E.2d 24, 31 (Ill. 1976); *Joseph v. Markovitz*, 551 P.2d 571, 576-77 (Ariz. Ct. App. 1976). Some decisions appear to permit the insurer to select "independent" counsel, when there is a disqualifying conflict. See, *e.g.*, *Patrons Mut. Ins. Ass'n v. Harmon*, 732 P.2d 741, 745 (Kan. 1987) (noting that when the insurer provides a conditional defense, the insurer should also provide independent counsel). "Independent counsel" appears here to mean counsel without any financial or professional ties to the insurer. See, *e.g.*, *Fireman's Fund Ins. Co. v. Waste Mgmt. of Wis., Inc.*, 777 F.2d 366, 370-71 (7th Cir. 1985) (finding that long professional relationship negated claim that counsel was independent). A third approach permits the insurer to participate in but not control the selection process when a disqualifying conflict exists. See, *e.g.*, *Employer's Fire Ins. Co. v. Beals*, 240 A.2d 397, 403 (R.I. 1968), *abrogated on other grounds*, *Peerless Ins. Co. v. Viegas*, 667 A.2d 785, 789 (R.I. 1995). A fourth approach is to establish statutory criteria which control the policyholder's discretion in selecting defense counsel when a disqualifying conflict has divested the insurer of its right to control the defense. See CAL. CIV. CODE § 2860(c) (West 1993) (requiring that independent defense counsel selected by the policyholder have certain minimum qualifications: (1) at least five years of tort litigation practice which includes substantial defense experience; and (2) errors and omission cover-

This bifurcation created several problems. Quality control over counsel selected by the policyholder has received some attention, as has cooperation between the insurer and defense counsel selected by the policyholder.⁹⁸ The biggest problem is the one that has received no specific attention: what is the approval or funding obligation of the insurer when the policyholder is in control of the defense because of a conflict of interest? If the policyholder negotiates a "within policy limits" settlement and asks the insurer to approve the settlement or fund the settlement, or both, what are the insurer's obligations and what consequences follow if the settlement fails for lack of insurer approval or funding? If the policyholder litigates and loses and a general verdict and judgment are entered, to what extent is the insurer bound by that judgment? How much leeway does the insurer have to contest the verdict in the underlying action? In the insurer-breach context, the insurer acted at its peril for the insurer was usually saddled with an adverse resolution of each of the above questions. Do the same perils exist for the conditionally defending insurer that fails to approve or fund a settlement negotiated by the policyholder in control of the defense for reasons other than insurer-breach of duty to defend?

We might begin by comparing the issue of control of the defense in the standard unconditional defense case, the insurer-breach case, and the conditional defense/conflict of interest case. All consequences to the insurer that naturally follow from its control of the defense are lacking when actual control is exercised not by the insurer but by the policyholder. Insurer control of the defense distinguishes the unconditional defense from insurer-breach, but insurer control does not necessarily distinguish the unconditional defense from the conditional defense. Under a conditional defense, the insurer may or may not be in control of the defense depending on why the conditional defense was interposed. Moreover, when insurer loss of control occurs, it is not due to insurer breach of duty, but arises out of the insurer's exercise of the right to maintain a conditional defense to preserve its ability to contest coverage. The "conflict of interest" does not arise out of any "fault" or "wrongdoing" on the part of the insurer or the policyholder. The "conflict of interest" simply represents a factual consequence of the exercise of contractual rights by the policyholder (the tender) and judicially implied rights of the insurer (the conditional defense).

There are, however, also factors common to the conditional defense/conflict of interest case, the unconditional defense case, and the insurer-breach case. While the insurer may be deprived of the power to control the defense, the insurer may still retain the other obligations imposed by the duty to defend, such as paying for the defense and claim adjustment. In discharging its retained obligations, the insurer must do so consistent with its duty of good

age. The insurer's payment obligation is, moreover, capped at the amount the insurer usually pays defense counsel it retains to defend its policyholders for similar type claims. *Id.*

⁹⁸ See CAL. CIV. CODE § 2860(c), discussed *supra* note 97; see generally Charles Silver, *When Should Government Regulate Lawyer-Client Relationships? A Call For Inaction* (to be published in a forthcoming issue of the University of Arizona Law Review; paper on file with the author) (discussing on-going battle between defense counsel and insurers, as waged in the courts and bar ethics committees, over (1) litigation guidelines imposed by insurers on retained defense counsel and (2) billing audits).

faith and fair dealing. The insurer's ability to carry out its retained obligations may, however, be impacted by its loss of control. For example, the insurer's ability to investigate and evaluate settlement may be impaired if the policyholder does not share litigation discovery with the insurer. Whether and to what extent claim adjustment obligations should be imposed on the insurer after it has lost the power to control the defense due to a conflict of interest remains an unresolved area of the law.

To explore these issues, let us assume a policyholder negotiated settlement of the hypothetical battery claim discussed earlier. The claimant will accept an amount equal to "policy limits." Let us also assume that there is a greater than remote chance that if the settlement is not completed and the matter goes to trial, an "excess policy limits" verdict is possible. The policyholder has insufficient assets to fund the settlement and the claimant insists on immediate funding as a condition of settlement. In other words, the settlement will fail unless it is funded by the insurer. How should the insurer respond to the funding request by the policyholder?

The insurer may have two concerns regarding the settlement. First, the insurer may believe that the claim is outside coverage. This was the basis for the conditional defense. The insurer's willingness to fund the settlement will thus be highly correlated to its position on coverage and its confidence that its position will be accepted as legitimate or as being based on good faith.⁹⁹ Second, the insurer may oppose settlement for strategic reasons believing either that the policyholder should not have settled or that the policyholder settled for too much. The insurer may believe the claim is defensible and that any settlement is unwise.¹⁰⁰ If the insurer's policy limits are the sole source of funding, the insurer may believe that the policyholder failed to evaluate settlement options with the same degree of care and prudence that the policyholder would have exhibited if its own money were at risk.

A different constellation of considerations affect the conditionally defending insurer that retains control of the defense. If the insurer's range of considerations in evaluating settlement offers is limited, the issue of funding the settlement is largely mooted. The failure to settle exposes the insurer to extracontractual damages based on a breach of duty theory. If the insurer is permitted to resist settlement based on reasonable doubts regarding coverage,

⁹⁹ Many jurisdictions treat the insurer's refusal to settle as being in good faith if coverage is "reasonably debatable." If the insurer errs in good faith, the policyholder is limited to contractual damages, which would be policy limits. See, e.g., *Mowry v. Badger State Mut. Cas. Co.*, 385 N.W.2d 171, 179-80 (Wis. 1986). Some jurisdictions refuse to permit the insurer to use doubts about coverage as an excuse for failing to resolve a claim. See, e.g., *Johansen v. Cal. State Auto. Assn. Inter-Ins. Bureau*, 538 P.2d 744, 748-49 (Cal. 1975) (holding that the only permissible consideration the insurer in control of the defense may allow for in evaluating a settlement offer is whether, in light of the claimant's injuries and probable liability of the policyholder, the ultimate judgment is likely to exceed policy limits). Whether *Johansen* would be applied when the insurer does not control the defense is unresolved.

¹⁰⁰ The insurer may have reputational interests that discourage settlement. See Gross & Syverud, *supra* note 82, at 52 (noting that strategic bargaining requires strategic intransigence and thus defendants will persist in low ball offers across the board even if in some cases raising the offer would be justified on the merits); see also Gross & Syverud, *supra* note 24.

the issue of funding settlements becomes critical to settlement clearance rates. The importance of the resolution of the issue of settlement funding is fundamental.¹⁰¹ If the insurer must fund the settlement immediately, the insurer is relegated to an after-the-fact recoupment action against the policyholder.¹⁰² When the insurer defends conditionally but retains control of the defense, the insurer funds the settlement, more out of custom and habit, or perhaps caution, than declared rule of law. The insurer has been allowed to seek recoupment from the policyholder on the basis that the claim settled was not covered.¹⁰³ Should a conditionally defending insurer not in control of the defense have the same settlement funding obligations as have been "assumed" to exist when the insurer controls the defense?¹⁰⁴ The position asserted here is that it should not: the obligation to fund a settlement should follow control of the defense, not the duty to defend.

¹⁰¹ In *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980), the court addressed the converse problem of the policyholder who chose to litigate rather than settle. In that context, the court stated the policyholder in control of the defense did not owe an excess insurer a duty to accept a reasonable settlement that would not impact the excess coverage. *Id.* at 1043. The policyholder's strategic decision to reject the offer within the self-insured retention and litigate for a defense verdict resulted in a judgment that required a monetary contribution by the excess insurer.

¹⁰² These reimbursement cases can be a technical morass. See, e.g., *Med. Malpractice Joint Underwriting Ass'n of Mass. v. Goldberg*, 680 N.E.2d 1121 (Mass. 1997):

Where an insurer defends under a reservation of rights to later disclaim coverage, as JUA did here, it may later seek reimbursement for an amount paid to settle the underlying tort action only if the insured has agreed that the insurer may commit the insured's own funds to a reasonable settlement with the right later to seek reimbursement from the insured, or if the insurer secures specific authority to reach a particular settlement which the insured agrees to pay. The insurer may also notify the insured of a reasonable settlement offer and give the insured an opportunity to accept the offer or assume its own defense. None of those conditions was met by JUA. Its original reservation of rights letter sent to Goldberg did not make any reference to settlement or to its right later to claim for reimbursement of any settlement. Nor does the correspondence with Barshak provide the necessary authority. JUA did not notify Goldberg of the settlement offer received from Witherspoon and JUA did not give Goldberg the opportunity to accept that settlement, or to assume his own defense.

Id. at 1129 (footnotes omitted).

¹⁰³ The whole area of conditional defenses and the insurer's ability to litigate coverage issues remains an area of substantial decisional uncertainty. See *supra* note 89; see also *Jacob v. W. Bend Mut. Ins. Co.*, 553 N.W.2d 800, 805 (Wis. Ct. App. 1996) (holding that "the law does not bind the insurer to the tactics and strategy selected by the insured's attorney, thereby depriving the insurer of its coverage defense if that strategy should fail"); compare *Sentinel Ins. Co., Ltd. v. First Ins. Co. of Haw., Ltd.*, 875 P.2d 894, 911 (Haw. 1994) (holding that "[c]ollateral estoppel applied between the insured and insurer is predicated upon an assumed identity of interests of the parties to the contract of indemnity in opposing the injured person's claim") (citing *Farmers Ins. Co. v. Vagnozzi*, 675 P.2d 703, 706 (Ariz. 1983)). While collateral estoppel would not apply to those issues as to which the interests of the policyholder and the insurer were in conflict, it is unclear whether the presence of a conflict as to some issues would divest the prior adjudication of any collateral estoppel effect. See *Manzanita Park, Inc. v. Ins. Co. of N. Am.*, 857 F.2d 549, 553 (9th Cir. 1988) (holding the better rule is to suspend operation of collateral estoppel even issues as to which policyholder and insurer share a common interest when there is a conflict of interest).

¹⁰⁴ The basis for the "assumption" is discussed at *supra* notes 105-06 and accompanying text.

Limiting the value of the insurer's "right" to contest indemnity coverage by requiring settlement funding effectively reduces the practical value of the conditional defense. By offering a conditional defense, the insurer may lose control of the defense. A conditional defense, even with a right of recoupment against the policyholder, could be strategically worse for the insurer than an unconditional acceptance of the tender. If the conditionally defending insurer not in control of the defense is required to fund a settlement negotiated by the policyholder, then the insurer may prefer to exercise control of the defense to protect its interests by minimizing its defense costs and avoiding the policyholder's biases towards settlement. It must be borne in mind that at the time the insurer offers the conditional defense, the insurer cannot always foresee whether the policyholder is entitled to claim control over the defense and, if so, whether the policyholder will exercise that right. Consequently, offering a conditional defense is not risk free even in jurisdictions which permit the insurer to impose a conditional defense unilaterally through a reservation of rights. The insurer must consider the risk of loss of control. This risk is enhanced if the loss of control does not affect the insurer's settlement funding obligation.

The alternative of permitting the insurer to refuse to fund a settlement when conditionally defending but not in control of the defense also raises problems. The loss of a funding source for settlement hollows out policyholder control of the defense whenever the policyholder is prevented from exercising the power of closure that a settlement provides. In some cases, the policyholder has nothing to offer to induce the claimant to compromise the claim: any settlement must be "subject to" the subsequent action in which the insurer's indemnity obligations will be determined. If there is no coverage, the real value of the settlement may be zero. This reality may encourage the policyholder to enlist the claimant as an ally against the insurer in an effort to induce a settlement by directing the claimant toward a solvent defendant. Any resolution of this problem will impose some costs on one of the parties to the insurance contract.

A few cases have finessed the issue by distinguishing between advancing funds and paying an indemnity. These cases have all followed the same general theme. The insurer has conditionally defended under a reservation of rights and retained control of the defense. The reservation of rights has included a provision stating that if the insurer settles the case, the insurer will look to the policyholder for reimbursement of the funds advanced if it is subsequently determined that the claim is not covered. The presence of a reimbursement obligation in a document drafted by the insurer can reasonably be construed as including the implied promise that the insurer will advance the funds necessary to settle the claim, at least up to policy limits. Courts have generally upheld these reimbursement provisions.¹⁰⁵ The courts have also stated that the presence of a reimbursement provision is required if the insurer

¹⁰⁵ See, e.g., *Omaha Indem. Ins. Co. v. Cardon Oil Co.*, 687 F. Supp. 502, 504-05 (N.D. Cal. 1988); *Blue Ridge Ins. Co. v. Jacobsen*, 22 P.3d 313 (Cal. 2001) (indemnity); *Buss v. Sup. Ct.*, 939 P.2d 766 (Cal. 1997) (defense costs).

wishes to recoup the settlement costs from the policyholder.¹⁰⁶ This, of course, begs the question and places the insurer in a "Catch 22" position: include a reimbursement provision and incur an obligation to fund the settlement, or omit the reimbursement provision and lose the right to recoup the settlement funds advanced, but still perhaps have a duty to advance funds. The courts have not resolved whether a conditionally defending insurer, with or without a reimbursement provision in its reservation of rights letter, must fund a reasonable settlement before the insurer has obtained a coverage determination.

The resolution of the question whether the conditionally defending insurer must advance settlement funds cannot be obtained from the language of the insurance contract. On this issue the policy is silent. One could infer that the absence of an express, independent "duty to settle" should be interpreted as excusing the insurer from having an obligation to advance settlement funds in the conditional defense setting. Courts have, however, proven to be noticeably reluctant to read the gaps in an insurance contract in a manner favorable to insurers except in matters when doing so would be wholly consistent with clear public policies. The conditional defense/settlement funding issue may not rise to this level. Reasonable arguments can be made for both requiring and excusing the insurer from funding a settlement when conditionally defending. The resolution requires a balanced, nuanced approach to the problem. Any solution must reflect the abilities of the parties to protect their own interests and represent a coherent and consistent approach to identifying the obligations and rights of the parties to the insurance contract. I will attempt such a reconciliation in Part VI of this article.

Decisions addressing policyholder settlement in derogation of the insurer's right to control the defense are only indirectly on point because the key issue in those decisions is liability for the settlement, not the timing of any funding obligation; nonetheless, the decisions use approaches to the problem that are helpful here. One approach is that the policyholder's breach and intrusion into the insurer's right of control excuses the insurer from its duty to indemnify.¹⁰⁷

¹⁰⁶ See *infra* notes 126-29 and accompanying text (discussing ability of conditionally defending insurer advancing settlement funds to secure reimbursement from the policyholder).

¹⁰⁷ See *Romstadt v. Allstate Ins. Co.*, 59 F.3d 608, 613-14 (6th Cir. 1995) (holding that "[w]here the insurer did not refuse to defend its insured," the insured's breach of the clause prohibiting voluntary payments to the claimant by the policyholder will be enforced and the policyholder's breach of that provision will not be excused). The cases become more conflicted when the insurer has the power but not the duty to defend as, for example, is the case with excess insurers. *Champion Spark Plug Co. v. Fid. & Cas. Co. of N.Y.*, 687 N.E.2d 785, 793 (Ohio Ct. App. 1996) (holding that policyholder's voluntary settlement without notice to excess insurers constituted breach of contract excusing insurer's duty to pay); but see *Cessna Aircraft Co. v. Hartford Accident & Indem. Co.*, 900 F. Supp. 1489, 1517-18 (D. Kan. 1995) (holding that policyholder's breach of no voluntary payment provision did not excuse excess insurer's duty to pay absent a showing of prejudice to interests of insurers).

A similar approach is seen in the decisions when the issue involves the policyholder's failure to cooperate in the defense of the claim. See, e.g., *State Farm Mut. Auto Ins. Co. v. Davies*, 310 S.E.2d 167 (Va. 1983) (permitting the insurer that had accepted tender of the defense to raise in garnishment action the policyholder's failure to cooperate and assist in the defense). The jurisdictions vary as to whether the failure to cooperate must prejudice the insurer and, if so, the measure of prejudice. JERRY, *supra* note 1, at § 110.

The "excuse" approach straightforwardly emphasizes the policyholder's "breach" as the determinative factor in decision analysis. A significant minority of jurisdictions have, however, adopted an alternative approach. These jurisdictions downplay the issue of breach and replace it with the concept of prejudice.¹⁰⁸ Under the "prejudice" approach, the insurer's duty to indemnify is not excused by the policyholder's breach unless the insurer can show actual harm caused by the policyholder's actions. In effect, the insurer must show that it could have compromised the claim for less or successfully defeated the claim but for the intervention of the policyholder. This may be a difficult proof. The insurer cannot expect any assistance here from either the claimant or the policyholder because any assistance rendered to the insurer would undermine the settlement the claimant and policyholder negotiated and jointly wish to assert against the insurer.

Different value systems may be identified as reflecting differences in judicial attitudes as to whether the policyholder's independent settlement deprives the insurer of the substantial benefits of the bargain. The view that treats the policyholder's settlement as excusing the insurer's performance holds that the right to control the defense has substantial value in its own right. This view treats the insurer's right to control the defense as integral to its ability to reduce its claim expense and prevent claimants from exploiting differences between policyholders and insurers to obtain settlements at sums the insurer is unprepared to offer.¹⁰⁹ Because loss experience influences both functions, this view may be seen as long term since it ties into the insurer's claim adjusting and underwriting functions. It may be expected, as discussed previously, that insurer control of the defense will result in settlement costs on average lower than policyholder controlled settlements when the policyholder is settling with the insurer's money.¹¹⁰ The "excuse" approach would thus couple the insurer's

¹⁰⁸ Many of these decisions involve the interplay between uninsured or underinsured motorist coverage and the insurer's subrogation rights against the tortfeasor. Standard coverage usually finds the policyholder suing the tortfeasor and looking to the insurer to cover the difference between the tortfeasor liability limits, if any, and the policyholder's uninsured/underinsured limits. The insurer is protected from collusive or unreasonable settlements between the policyholder and tortfeasor, which would shift the costs of policyholder's claim to the insurer, by the presence of a consent to settle provision. A debate exists whether the breach of the consent clause by the policyholder excuses the insurer's duty to pay absent a showing of prejudice, *i.e.*, the insurer could have collected more from the tortfeasor. *Federated Serv. Inc. Co. v. Grandos*, 889 P.2d 1312, 1314 (Or. Ct. App. 1995) (adopting prejudice requirement on the theory that "consent-to-settle" provision is a "condition to" rather than an "exclusion from" coverage); *contra* *Motorist Mut. Ins. Co. v. Handlovie*, 492 N.E.2d 417, 419 (Ohio 1986); *March v. Mountain States Mut. Cas. Co.*, 687 P.2d 1040, 1044 (N.M. 1984). *See also* *Malmin v. Minn. Mut. Fire & Cas. Co.*, 552 N.W.2d 723 (Minn. 1996) (collecting decisions discussing whether consent to settle clause is enforceable in a no fault jurisdiction and adopting the position that it is not).

¹⁰⁹ *Ill. Masonic Med. Ctr. v. Turegum Ins. Co.*, 522 N.E.2d 611, 613 (Ill. App. Ct. 1988) (noting that control of the defense permits insurers to protect their financial interests in the outcome of the litigation and to minimize unwarranted liability claims); *see generally* Douglas Richmond, *Liability Insurer's Right to Defend Their Insureds*, 35 CREIGHTON L. REV. 115, 116 (2001) (noting benefits of control of the defense for insurers).

¹¹⁰ There is, of course, the strategic possibility that if the policyholder cannot call on the insurer's resources this may benefit the policyholder's bargaining position. *See, e.g.*, *Md. Cas. Co. v. Knight*, 96 F.3d 1284, 1294 (9th Cir. 1996) (noting that policyholder's bank-

funding obligation to its control of the defense. If the insurer was not in control of the defense, for reasons other than breach, the "excuse" approach suggests that no funding obligation should be recognized until the issue of indemnity was resolved.

The "prejudice" view emphasizes the near or short term consequences of the policyholder's conduct. If the policyholder settles the case for a reasonable amount, this view treats the insurer as not having been deprived of the substantial benefits of the bargain. Under this view, the policyholder's breach requires a showing of harm (prejudice) to be actionable.¹¹¹ This "prejudice" approach decouples funding and control. It suggests that the conditionally defending insurer who has lost control of the defense, for reasons other than breach, must fund a settlement negotiated by the policyholder unless the insurer can show actual harm, *i.e.*, the settlement was unreasonable, fraudulent, or the product of collusion and, thus, resulted in a settlement substantially in excess of the actual value of the claim.

V. THE NON-STANDARD CASE: POLICYHOLDER IN CONTROL OF THE DEFENSE PURSUANT TO THE AGREEMENT OF THE PARTIES

The policyholder may contractually assume control of the defense. This may arise for a variety of reasons. The insurance contract may be a pure indemnity contract.¹¹² Alternatively, the policyholder may have a large self-insured retention or the policyholder may be using a non-traditional form of insurance, such as a captive or a fronting policy.¹¹³ Each of these alternative insuring formats effectively places the policyholder in the role assumed by a primary insurer with responsibility for the working layer of coverage.

ruptcy probably enhanced policyholder's bargaining leverage); THOMAS SCHELLING, *THE STRATEGY OF CONFLICT* (1963) (noting that in bargaining, "weakness" can be a strength when it forces an adversary to make concessions that a weak party cannot make because it is weak). While I do not discount the possibility that financial insolvency, or the perception thereof, may discourage claimants, the presence of liability insurance usually reflects the purchaser's informed decision that she has assets that warrant protection from the risk of civil litigation and civil liability.

¹¹¹ *New Eng. Extrusion, Inc. v. Am. Alliance Ins. Co.*, 874 F. Supp. 467, 470-71 (D. Mass. 1995) (holding that policyholder's voluntary settlement in breach of voluntary payments provision of policy did not excuse insurer's performance absent showing of prejudice).

¹¹² The fact that a policy is written as a pure indemnity policy is not necessarily controlling. If the insurer has agreed to reimburse the policyholder for defense costs on an "as accrued" basis, the insurer's failure to reimburse those costs has been treated by some courts as equivalent to the breach of the duty to defend and permit extracontractual remedies. See *Lexington Ins. Co. v. Devaney*, 50 F.3d 15 (Table), 1995 WL 105985, at *2 (9th Cir. Mar. 9, 1995) (citing *Xebec Dev. Partners, Ltd. v. Nat'l Union Fire Ins. Co.*, 15 Cal. Rptr. 2d 726, 739 (Ct. App. 1993)); compare *Valassis Communications, Inc. v. Aetna Cas. & Sur. Co.*, 97 F.3d 870, 876 (6th Cir. 1996) (stating that under Michigan law provision in insurance contract providing for reimbursement of defense costs does not create duty to defend).

¹¹³ A "captive" is an insuring entity that is owned by the policyholder. *Westchester Fire Ins. Co. v. Hedington Ins. Ltd.*, 883 F. Supp. 158, 160 n.4 (S.D. Tex. 1995), *aff'd* 84 F.3d 432 (5th Cir. 1996) (Table). A "fronting" arrangement involves an insurer which allows its name to be used by the nominal policyholder. The policyholder agrees to pay the fronting insurer a fee and to hold it harmless from all losses relating to the fronted policy.

The critical issue is whether the policyholder in control of the defense owes the same duties of good faith and fair dealing to the insurer that the insurer in control of the defense owes the policyholder. Note that the implicit assumption beneath the argument is that the policyholder's conduct of the defense is to some extent binding on the insurer. If the insurer is free to litigate all aspects of the validity of the claim and its coverage under the insurance contract, the need to hold the policyholder to good faith in the conduct of the defense is substantially reduced, if not eliminated.

In addressing the issue of "good faith," policyholders have usually argued literalism and definition: a policyholder is not an insurer; therefore, the rules applicable to insurers in control of the defense do not apply to policyholders in control of the defense, even for policyholders acting like insurers. Insurers have made the "walks like a duck" argument: a policyholder that acts like an insurer, should be held to the standards imposed on insurers in control of the defense. Although the case law is thin, the policyholders' position has seen more success in this area than the insurers'. As long as the policyholder seeks to advance no more than its own litigation-related, economic interests, the policyholder's conduct does not provide the insurer with an excuse for non-performance.¹¹⁴ Insurer successes have involved instances of policyholder duplicity and overreaching.¹¹⁵ A few courts have suggested that the policyholder's discretion is circumscribed by the implied covenant of good faith and fair dealing, but those cases have involved the policyholder's failure to give notice, rather than poor claims handling or claims evaluation.¹¹⁶

Although there are some similarities between the policyholder in control cases due to conflict of interest and the policyholder in control cases due to agreement between the parties, I do not believe the categories are congruent.

¹¹⁴ The model case involves a policyholder who rejects a settlement that would avoid breaching the policyholder's self-insured retention. This is the converse of the insurer's failure to settle the case. Here, if the policyholder erroneously rejects the offer, the insurer pays. Nonetheless, the unanimous judicial response is to allow the policyholder to prefer its own economic interests by rejecting the offer in the hope of doing better later. *See, e.g.,* Employers Mut. Cas. Co. v. Key Pharm., Inc., 871 F. Supp. 657, 665 (S.D.N.Y. 1994); Int'l Ins. Co. v. Dresser Indus., Inc., 841 S.W.2d 437, 445 (Tex. Civ. App. 1992); Commercial Union Assurance Cos. v. Safeway Stores, Inc., 610 P.2d 1038 (Cal. 1980). A similar conflict arises when the policyholder is self-insured and an insurer seeks to avail itself of its other insurance clause. Here the decisions are less uniform but still appear to favor the policyholder on the rationale that "self-insurance" is not "insurance." *See generally* James Fischer, *The Presence of Insurance and the Legal Allocation of Risk*, 2 CONN. INS. L.J. 1, 40-44 (1996).

¹¹⁵ *Cf. Kaiser Found. Hosp. v. N. Star Reinsurance Corp.*, 153 Cal. Rptr. 678, 682-83 (Ct. App. 1979) (holding that an excess insurer was not bound by claim assignments to particular policy periods agreed to between the policyholder and the primary insurer when the assignments operated to expand the excess insurer's obligations and limit the primary insurer's obligations); *see also* First State Underwriters Agency of New Eng. Reinsurance Corp. v. Travelers Ins. Co., 803 F.2d 1308, 1314-15 (3d Cir. 1986) (holding that the excess insurer may challenge the dates of loss assigned by the policyholder and the primary insurer); *Home Ins. Co. v. Am. Home Prod. Corp.*, 665 F. Supp. 193 (S.D.N.Y. 1987) (same), *aff'd in part, rev'd in part on other grounds*, 902 F.2d 1111 (2nd Cir. 1990).

¹¹⁶ *N. Am. Van Lines v. Lexington Ins. Co.*, 678 So. 2d 1325, 1331-32 (Fla. Dist. Ct. App. 1996); *Diamond Heights Homeowners Ass'n v. Nat'l Am. Ins. Co.*, 277 Cal. Rptr. 906, 914 (Ct. App. 1991).

The chief similarity is the absence of breach. The differences, however, are more significant. When the policyholder controls the defense by agreement with the insurer, the parties have constructed the relationship so that policyholder control of the defense is the desired result. Both the policyholder and the insurer may be seen to have agreed that the insurer's obligation to provide indemnity will to some extent be controlled by the policyholder's handling of the claims. While the insurer has not expressly agreed to follow the fortunes of the policyholder,¹¹⁷ the insurer is not well positioned, given the structure of the relationship, to contend that it can be indifferent and unaffected by the actions of the policyholder. The settlement or judgment will probably be deemed binding on the insurer if the policyholder acted reasonably.¹¹⁸ It must be reemphasized, however, that binding the carrier to the underlying claim *resolution* is distinct from the determination whether that underlying claim is *covered* by the insurance contract.¹¹⁹

VI. A SUGGESTED UNIFORM APPROACH TO FUNDING SETTLEMENTS FOR NON-STANDARD, NON-BREACH CASES

This paper has identified several exceptions to the standard case of the unconditionally defending insurer. These include:

1. The insurer in breach of its duty to defend;
2. The conditionally defending insurer that retains control of the defense;
3. The conditionally defending insurer that loses control of the defense;
4. The insurer that cedes by contract control of the defense to the policyholder.

The insurer-breach cases have dominated the decisional law. It would be a mistake, however, to extend the doctrine of the breach cases to non-breach contexts. The absence of fault in the non-breach cases negates a direct application of the insurer-breach model created by the courts. The non-breach, non-standard case must be analyzed on the basis of criteria that recognize that the

¹¹⁷ In the reinsurance context, the relationship is controlled by the "follow the fortunes" provision, which has been held to bind the reinsurer to the claim decisions made by the ceding insurer. *N. River Ins. Co. v. CIGNA Reinsurance Co.*, 52 F.3d 1194, 1199 (3d Cir. 1995) (stating that "follow the fortunes" clauses prevent reinsurers from second guessing good faith settlements and obtaining *de novo* review of judgments of the reinsured's liability to its insured [the ceding insurer]"); Debra Baker, *The Effect of Evidence of Industry Custom and Practice and the Parties' Course of Dealing on the Application of "Follow the Fortunes" in Reinsurance Contracts*, 31 TORT & INS. L.J. 947 (1996). Follow the fortunes or follow the settlements provisions have generally been limited to reinsurance contracts and have not spread to other contexts where the policyholder is in control of the defense by agreement.

¹¹⁸ See *Armstrong World Indus., Inc. v. Aetna Cas. & Sur. Co.*, 52 Cal. Rptr. 2d 690, 729-30 (Ct. App. 1996); *Monarch Cortland v. Columbia Cas. Co.*, 646 N.Y.S.2d 904, 906 (App. Div. 1996); cf. *UNR Indus., Inc. v. Cont'l Cas. Co.*, 942 F.2d 1101, 1106 (7th Cir. 1991) (stating that an excess insurer could not contest the reasonableness of a settlement entered in its absence and without its participation. Collusion was deemed not a concern because the settlement was approved in adversarial proceedings before the bankruptcy court and the insurer's position had been represented by other parties).

¹¹⁹ Cf. *Gulf Res. & Chem. Corp. v. Gavine*, 763 F. Supp. 1073, 1077-78 (D. Idaho 1991) (holding that there was no obligation on part of excess insurer to pay uncovered claim that was settled by the policyholder).

situation, while not unforeseeable, is largely unprovided for under the terms of the insurance contract. Because the problem is foreseeable, courts should adopt an approach which (1) is consistent with the contractual relationship that exists between insurer and policyholder, (2) advances policies for which liability insurance is directed, namely, the use of insurance as a source of funds for dispute resolution, yet (3) does not unduly distort the objective bargain reached by the parties.

While there are differences between the non-standard, non-breach categories, a uniform approach to the program is both available and preferable. Even if the insurer has continuing claim adjustment responsibilities that are independent of its litigation defense obligations, the close nexus between control of the litigation defense and settlement, particularly settlement tactics, warrants an approach that marries the two concerns rather than separates them. Such an approach is available and feasible. Settlement funding obligations should be initially assigned to the party in actual control of the defense. Reimbursement for settlement funds advanced should be allowed. The insurer in control of the defense would have a right of reimbursement when it funded a settlement if it was subsequently determined that no duty to indemnify existed. The policyholder in control of the defense, for reasons other than insurer breach, would have a right of reimbursement when it funded the settlement of a claim for which the insurer had a duty to indemnify. Reimbursement should not, however, be conditioned on the party funding the settlement giving the reimbursing party an opportunity to consent or object to the settlement.

A. The Party In Control of the Defense Should Advance Funds To Settle The Claim

Funding should be attached to control because settlement has become an ingrained part of the civil justice system, particularly in the personal injury/property damage fields in which liability insurance is centrally located. Efforts to bifurcate settlement of the suit from control of the defense are impractical and inefficient.

Impracticality is the product of the demands of the litigation system which requires that a defense be aligned with the economic and litigation realities of the case. A matter with an expected value of \$1,000,000 is a different case from a matter with an expected value of \$1,000. Pretrial strategy and negotiation strategy are not tactics that are kept in separate boxes; one being put away when the other is being used. Pretrial strategy (control of the defense) is inextricably connected with negotiation and settlement strategy. How much and what type of discovery to conduct, whether expert witnesses should be retained now or later or ever, whether to move for summary adjudication, are all issues that are influenced, and in turn influence, negotiation looking to dispute resolution. An adversary's valuation of a claim must necessarily be influenced by what is learned and by what is disclosed through the pre-trial; however, control of the defense is control over pre-trial. Bifurcating responsibility for control of the defense from responsibility for claim valuation for settlement purposes is

highly likely to raise litigation costs due to miscommunication and misdirection between the party responsible for each of the bifurcated tasks.¹²⁰

Having to maintain open lines of communication with multiple persons to resolve the dispute may be counterproductive and inefficient. The fact that multiple persons face a common adversary (the claimant) cannot completely override the fact that the personal, business, and litigation interests of the insurer and the policyholder do not always coincide. Of course, the absence of coherence will have to be addressed eventually, but it is dangerous to require the parties to resolve their differences while they face a common opponent who may seek to exploit their differences for the opponent's advantage through divide and conquer tactics.¹²¹ Moreover, the need to communicate in order to conclude the dispute raises transaction costs by increasing the number of parties needed to resolve the dispute from two (claimant and party in control of the defense) to three (claimant, party in control of the defense, and person who must advance settlement funds to resolve dispute).

Situating settlement funding responsibility in the party having control of the defense is most acceptable in two of the non-standard cases: (1) the conditionally defending insurer retains control of the defense; and, (2) the policyholder is contractually given control of the defense. In both of these cases, the party is in control because it has bargained for control and the party that ceded control did so consciously and voluntarily. The same bargain that gave one of the parties control also could have addressed, and sometimes does address, interim funding obligations.¹²² The absence of specific attention to the funding issue in the contract suggests a rule that would parallel the customary expectations of the parties. For the reasons discussed in this paper, the customary expectation should be to couple funding with control. This is enhanced when, as here, the parties have contractually structured a relationship that is expressly based on "after-the-fact" reimbursement rather than pre-funding.

¹²⁰ Courts have noted that bifurcation of settlement authority and litigation responsibility results in obstacles to judicial calendar management and dispute clearance rates. See *In re Novak*, 932 F.2d 1397, 1407-08 (11th Cir. 1991).

¹²¹ Commentators have noted the possibility of the claimant exploiting the insurer-policyholder relationship for personal gain. See, e.g., Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Counsel*, 1995 DUKE L.J. 255; Stephen Schmidt, *The Bad Faith Set Up*, 29 TORT & INS. L.J. 705 (1994).

¹²² Insurance contracts can provide for the obligation to fund a settlement subject to reimbursement if it is ultimately determined that the funding party is entitled to indemnity or restitution. For example, pure excess insurance contracts usually provide through the "ultimate net loss" and "loss payable" provisions that the policyholder have *paid* the loss before the insurer's duty to pay arises. Such language is usually respected and enforced by the courts. See, e.g., *Aetna Cas. & Sur. Co. v. Chicago Ins. Co.*, 994 F.2d 1254, 1257-58 (7th Cir. 1993); see also *St. Paul Fire & Marine Ins. Co. v. Gilmore*, 812 P.2d 977, 980 (Ariz. 1991) (finding that with excess insurance, scheduled underlying coverage "operate[s] as a kind of deductible, and 'an insured pays a reduced premium to the excess insurer expressly because that insurer will be obligated to pay a claim only after a certain amount has been paid' by the insured's primary insurer") (citation omitted).

Whether "actual payment" should be required in the settlement funding context is problematic. Actual payment is a good signal that the settlement was reasonable. On the other hand, payment may be beyond the financial resources of the party in control of the defense. If the claimant will settle and defer collection until coverage is resolved, interposing a payment requirement can be seen as an irrelevant formality.

Control of the defense necessarily affects claim value and the price for which the claim may be compromised. Bifurcating defense and settlement complicates each party's ability to control the defense and comply with the related duties of assistance, cooperation, and good faith. For example, if the insurer had defense obligations and control but no funding obligation, defense counsel would be retained by the insurer for that limited purpose. The claimant (and his lawyer) would, therefore, need to communicate directly with the policyholder regarding settlement funding. Although the policyholder is not being represented by defense counsel as to settlement, it is unclear whether communications between the policyholder and claimant's counsel would be ethically proper.¹²³ These "back channel" communications would, moreover, tend to undermine the more formal relationship between the policyholder and retained defense counsel. The policyholder could, moreover, be placed in a precarious position whenever its efforts on its own behalf to settle the claim conflict with the insurer's defense strategy. Efforts by the insurer to supervise or exercise oversight of the settlement process would be inconsistent with the insurer's "no duty to settle" position and could independently subject the insurer, or defense counsel, to liability. Any policyholder funding of a settlement negotiated or encouraged by the insurer could give rise to claims of insurer coercion and duress of the policyholder.¹²⁴

Assigning the funding obligation to the conditionally defending insurer when it is in control of the defense appears to be a pragmatic resolution of the problem. The insurer has some protection through the reimbursement mechanism, although the value of reimbursement is, of course, proportionate to the financial solvency of the policyholder. It permits the insurer to exercise meaningful control of the defense and avoids thrusting the policyholder into situations where its conduct may raise assistance and cooperation issues, unless the policyholder is permitted to look exclusively, and without penalty, to its own interest in considering settlement. Most importantly, imposing a limited funding obligation on conditionally defending insurers in control of the defense promotes settlements. While courts occasionally assert that coverage decisions are not dictated by a desire to provide compensation to claimants by maximizing coverage, the reality is, I believe, otherwise.¹²⁵ In this context, the insurer's

¹²³ See MODEL RULES OF PROF'L. CONDUCT R. 4.2 (1983) (prohibiting communication by a lawyer representing a client with a person the lawyer knows to be represented by another lawyer, when the communication concerns the subject of the representation, without the consent of the other lawyer).

¹²⁴ See, e.g., *J.B. Aguerre, Inc. v. Am. Guar. & Liab. Ins. Co.*, 68 Cal. Rptr. 2d 837, 842 (Ct. App. 1997) (concluding that the insurer potentially can be liable for coercing a policyholder to contribute to a settlement fund when the case settled within policy limits).

¹²⁵ Compare *Keene Corp. v. Ins. Co. of N. Am.*, 667 F.2d 1034, 1041 (D.C. Cir. 1981) (adopting coverage position (continuous trigger) on the ground, among others, that it would maximize the amount of available insurance for the policyholder), with *Owens-Ill., Inc. v. United Ins. Co.*, 650 A.2d 974, 981 (N.J. 1995) (stating that "the presumption of maximizing coverage . . . appears an uneven principle in this setting A rule of law premised on nothing more than the result-oriented goal of maximizing coverage has been described as 'judicial legislation'") (citation omitted); *Abex Corp. v. Md. Cas. Co.*, 790 F.2d 119, 126 n.32 (D.C. Cir. 1986) (noting that goal of "maximizing coverage" is result oriented).

I have attempted to chronicle what I contend is the consistent judicial tendency to match insurance with the party who bears the risk of loss in James Fischer, *The Presence of Insur-*

interest in protecting its funds by retaining control may be balanced against increasing the amount, and speeding the delivery, of compensation to injured claimants.

A court creating a middle ground position (here the conditional defense) may attach such burdens to the position as are appropriate given the tradeoffs a middle ground position represents. Within the ambit of claims legitimately raising a conditional defense is the subset of claims that are covered and for which the insurer has full indemnity obligations and a subset of claims that are not covered and for which no indemnity is owed. We cannot resolve the matter based on the assumption that the conditionally defended claim is or is not covered. If the claim is not covered, imposing any funding obligation on the insurer seems wrong. The insurer should not be forced to pay non-covered claims in the guise of discharging its duty to defend covered, or potentially covered, claims. If, however, the claim is covered, imposing only a limited, after-the-fact funding obligation on the insurer seems wrong. The insurer should not be able to reduce its indemnity obligations by criticizing the breadth of its defense obligations. The correct perspective is that of uncertainty whether the claim is covered. It is from the perspective of uncertainty that the legal rule must be prescribed that assigns the benefits and burdens of a conditional defense. Under these conditions of uncertainty, assigning a funding obligation to the party that has contractually assumed control of the defense is neither improper nor unwarranted; rather, it reflects a sharing of the possible outcomes in a manner that permits both insurer and policyholder to protect their own positions without inflicting unreasonable harm on the other.

This leaves the case involving the policyholder in control of the defense due to the presence of a coverage conflict of interest. The central objection to requiring the policyholder in control of the defense due to a coverage conflict to fund a settlement is that it deprives the policyholder of a benefit that it is entitled to under the contract – insurer adjustment of the claim. It is the common understanding of the concept of claim adjustment that the insurer initially determines the amount that will be offered to settle the claim – and thus the amount of indemnity the policyholder is entitled to recover under the insurance contract. Decoupling the funding obligation from the adjusting function appears to eviscerate the purpose of insurer adjustment.

The problem with the evisceration argument, as applied to this situation, is that it decides the contested issue by assuming that the insurer must advance funds even though it has properly reserved its rights to contest its indemnity obligations. The position advanced here preserves the insurer's right to reserve its indemnity obligation while recognizing that some neutral mechanism needs to be identified that addresses the practical need of assigning to one of the parties to the insurance contract an interim funding obligation. While courts could decide to impose such an obligation on the insurer, such a decision would unwisely extend the insurer's defense obligation by effectively collapsing the defense and indemnity obligations under the broader duty to defend test. In other words, whenever the duty to defend was triggered, the conditionally

ance and the Legal Allocation of Risk, 2 CONN. L.J. 1 (1996). I concede my perception is based primarily on intuition and analysis of a limited set of appellate decisions, but I have found few counter-examples.

defending insurer would have a duty to fund settlements, whether negotiated by it or by the policyholder due to a conflict of interest. I believe that assigning the funding obligation to the conditionally defending insurer in control of the defense is justified not by reference to the insurance contract, for the insurance contract is silent here, but is justified by the demands of conducting a defense and the impracticality and inefficiency of the bifurcation alternative. These same reasons warrant assigning the funding obligation, subject to reimbursement, to the policyholder who elects to control the defense through the selection of independent counsel when a disqualifying conflict of interest precludes the insurer from exercising its contractual right to control the defense.

B. Reimbursement of Funds Advanced Should Not Be Conditioned On the Obtaining of Informed Consent From the Party With Final Responsibility for Payment

Reimbursement of settlement funds advanced by the conditionally defending insurer has generally been based on consent, not restitution.¹²⁶ The distinction is between a duty based on voluntary assumption of an obligation (consent) as opposed to the involuntary imposition of an obligation to avoid unjust enrichment (restitution). Under a consent theory, the parties to the bargain create the obligation; under a restitution theory, the obligation is created by law. "Consent" of the policyholder to reimbursement of the conditionally defending insurer is today usually obtained by inclusion of a reimbursement provision in the reservation of rights letter.¹²⁷ If the policyholder does not object, the conditional defense is impressed with a right of reimbursement for settlement funds advanced *if* it is ultimately determined that the settled claim was not covered. Because the foundation of reimbursement is consent by the policyholder, if the insurer fails to include a reimbursement provision in its reservation of rights letter, the insurer is denied reimbursement.¹²⁸

¹²⁶ *Ins. Co. of the W. v. Haralambros Beverage*, 241 Cal. Rptr. 427 (Ct. App. 1987):

With respect to equitable restitution, the general rule is that money voluntarily paid to another with knowledge of the facts cannot be recovered back. [In *Leshner v. Travelers Insurance Company*], the court denied an insurer equitable restitution of litigation costs, finding its primary motivation in defending under a reservation of rights was to protect its own interests and not those of its insured.

Id. at 434 (citation omitted), *disapproved on other grounds in* *Buss v. Superior Court*, 939 P.2d 766, 766 (Cal. 1997); *cf.* 1776 K Street Assoc. v. United States, 602 F.2d 354 (Ct. Cl. 1979), *cert. denied*, 447 U.S. 905 (1980) (holding that no restitution allowed when mistake is simply one of judgment).

¹²⁷ *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 126 Cal. Rptr. 267, 274 (Ct. App. 1975):

Absent an agreement by the insured – express or implied in fact – that the insurer may commit the insured's own fund toward any reasonable settlement, the insurer is not permitted to seek reimbursement for a particular settlement unless it has secured specific authority to make that settlement or has notified the insured of a reasonable offer by the claimant and given the insured an opportunity to assume the defense.

Id. at 267. In a bilateral "no waiver" agreement, reimbursement is clearly the result of mutual assent.

¹²⁸ *Gossard v. Ohio Cas. Group*, 35 Cal. Rptr. 2d 190 (Ct. App. 1995) (upholding right of reimbursement of *defense costs* when (1) the insurer defended under a reservation of rights with a specific reimbursement provision; (2) there was a declaration of non-coverage; and

Tying reimbursement to the policyholder's consent is based on a view of the insurer's ability to maintain a conditional defense that is dated.¹²⁹ Initial judicial approaches to unilateral efforts by insurers to defend conditionally were cautious. Courts were no doubt more comfortable with bilateral approaches, such as "no waiver" agreements.¹³⁰ To uphold unilateral assertions of conditional defenses, courts imposed a "consent by acquiescence" element. Because the policyholder could reject a conditional defense and force the insurer to either defend unconditionally or decline the tender, courts treated the policyholder's silence in the face of the tender of a conditional defense as the functional equivalent of an acceptance. Within this model it made sense to require that if the insurer wished reimbursement for funds paid to settle a claim, the insurer must state its desire for reimbursement and the terms of the defense in the reservation of rights letter so that the policyholder could "assent" to it, albeit if only by silence, or reject the defense and put the insurer to an election.

As conflict of interest issues generated by conditional defenses became more common between insurers and policyholders, the idea that a conditional defense was consensual began to fade. Increasingly, courts have upheld the *right* of the insurer to defend conditionally.¹³¹ Within a right-based model it is difficult to fix a notion of policyholder consent. If the insurer has the right to defend conditionally, it is erroneous to suggest that the policyholder's "consent" plays a role in the exercise of that right. Disclosure has also been justified under other theories. Failure to disclose a conditional defense has been

(3) the policyholder never objected to either the conditional defense or the reimbursement provision and by so doing acquiesced in the insurer's position), *hearing granted, appeal dismissed*, 47 Cal. Rptr. 2d 106 (Cal. 1995); *republished by* 909 P.2d 1 (1995). It is unclear whether a right to reimbursement can be imposed unilaterally by the conditionally defending insurer to the same extent as the conditional defense may be imposed unilaterally by the insurer. *Med. Malpractice Joint Underwriting Ass'n of Mass. v. Goldberg*, 680 N.E.2d 1121, 1129 (Mass. 1997); *Truck Ins. Exch. v. Superior Court*, 59 Cal. Rptr. 2d 529, 534 (Ct. App. 1996). Alternatively, the insurer may secure reimbursement from the policyholder following settlement if the insurer received "specific authority" from the policyholder to settle after the insurer defended conditionally. *Md. Cas. Co. v. Imperial Contracting Co.*, 260 Cal. Rptr. 797, 804 (Ct. App. 1989).

¹²⁹ See *supra* notes 37-41 and accompanying text. More recent decisions rely on principles of unjust enrichment. See, e.g., *Blue Ridge Ins. Co. v. Jacobs*, 22 P.3d 313, 319-20 (Cal. 2001).

¹³⁰ *Val's Painting & Drywall, Inc.*, 126 Cal. Rptr. at 272-73, (quoting 68 HARV. L. REV. 1436, 1446-47):

The distinction between a non-waiver agreement and a reservation of rights has been stated as follows: "... A non-waiver agreement is a bilateral contract, normally in writing, entered into by the assured and the insurer after the accident, providing that the insurer will defend the tort suit while reserving its right to assert non-liability under the policy at a later date A reservation of rights is very similar to a non-waiver agreement, and it is subject to the same limitations and restrictions. It differs in being less formal than the non-waiver and less tied to strict contract principles. The insurer need only notify, or attempt to notify, the assured that it is conducting the investigation and defense of the tort claim under a reservation of the right to assert policy defenses at a later time, and the assured's silence will usually be deemed acquiescence. Courts have in general been fairly liberal in implying reservations.

(citations omitted).

¹³¹ See *supra* note 89.

held to "estop" the insurer;¹³² alternatively, the insurer has been held to have "waived" its rights.¹³³ While both theories are closer to an insurer-right based model, in practice courts have frequently stretched the concepts to achieve a result closer to the policyholder consent model.¹³⁴

That reservation of rights letters should be treated as free from a "consent by the policyholder condition" does not mean that an insurer should be given *carte blanche* with respect to the conduct of its conditional defense. The insurer's actions under the contract are subject to the implied covenant of good faith and fair dealing.¹³⁵ The insurer cannot use the reservation of rights letter for strategic reasons unrelated to its legitimate belief that a coverage issue is present.¹³⁶ Thus, the insurer cannot interpose a conditional defense absent the good faith belief, at the time of the assertion of the reservation, that a coverage issue exists. A court could require (1) for evidentiary reasons, (2) to prevent future credibility contests, (3) to reduce the need for judicial dispute resolution, or (4) to prevent insurers from exploiting their control of the defense to find coverage defenses, that the basis and terms of the conditional defense be placed in the reservation of rights letter.¹³⁷ These practical reasons are, however, different from the bargain theory that generally has been used to date to support the reimbursement disclosure requirement.¹³⁸

The policyholder's rights are not directly affected by the presence or absence of a disclosure requirement unless the policyholder can object and put the insurer to an election. The recent trend of decisions suggests that a policyholder cannot reject a conditional defense with a right of reimbursement.¹³⁹

¹³² Draft Systems, Inc. v. Alspach, 756 F.2d 293, 296 (3d Cir. 1985) (citing C. J. APPLEMAN, INSURANCE LAW & PRACTICE §§ 4689, 4694 (W. Berdal ed., 1979)).

¹³³ Protective Ins. Co. v. Coca Cola Bottling Co., Indianapolis, Inc., 423 N.E.2d 656, 661 (Ind. Ct. App. 1981).

¹³⁴ Intel Corp. v. Hartford Accident & Indem. Co., 952 F.2d 1551, 1559 (9th Cir. 1991) (noting that in insurance context the line between waiver and estoppel has been blurred); KEETON & WIDISS, INSURANCE LAW, *supra* note 34.

¹³⁵ Guar. Nat'l Ins. Co. v. George, 953 S.W.2d 946 (Ky. 1997) (noting but not deciding that insurer could abuse its right to defend conditionally by requesting a court to determine coverage issues); Safeco Ins. Co. of Am. v. Butler, 823 P.2d 499, 504-05 (Wash. 1992) (holding that insurer that conducts conditional defense in bad faith loses privilege to contest coverage).

¹³⁶ Am. Eagle Ins. Co. v. Nettleton, 932 S.W.2d 169, 174 (Tex. App. 1996) (holding that an insurer has a right to provide a conditional defense "only when [it] has a good faith belief that the complaint alleges conduct which may not be covered by the policy").

¹³⁷ Courts have imposed such a requirement that has, in turn, generated a discrete body of law of estoppel and waiver regarding insurer efforts to augment the reasons given in the reservation of rights letter to defend conditionally. JERRY, *supra* note 1, at 798.

¹³⁸ Courts using the principle of unjust enrichment to support reimbursement have used a "demand" requirement to effect disclosure to the insured of the insurer's claim for reimbursement when defending conditionally. Blue Ridge Ins. Co. v. Jacobs, 22 P.3d 313, 320 (Cal. 2001).

¹³⁹ The traditional ground for requiring disclosure of the bases of the conditional defense is to permit the policyholder to be aware of potential conflicts of interest that would permit the policyholder to assume control of the defense. Cowan v. Ins. Co. of N. Am., 318 N.E.2d 315, 320-22 (Ill. Ct. App. 1974). The modern trend appears to be to not limit the insurer to the defenses listed in the reservation of rights letter unless the policyholder can show that less than full disclosure actually caused the policyholder prejudice. See Intel Corp., 952 F.2d at 1560-61.

This strongly suggests that the consent model is ill-suited to the present way courts are treating conditional defenses by insurers.

The consent model has also caused courts to undervalue the role of restitution as a basis for supporting reimbursement by the policyholder of the monies advanced by the insurer to settle the claim. Under the consent model, the parties have, from the court's perspective, contractually adjusted their rights and duties. Restitution may be seen as an improper intrusion into the parties' private arrangements when consent is the basis of the obligation.¹⁴⁰ However, if the insurer is permitted to exercise unilaterally the right to a conditional defense, the use of consent as legitimizing the insurer's conduct is undermined. On the other hand, absent consent, the insurer's action may benefit the policyholder in a manner that requires adjustment to avoid the policyholder's unjust enrichment. For example, if the claim is not covered, the policyholder would receive a windfall in the form of an extra-contractual benefit were the insurer denied reimbursement of settlement funds. The policyholder would receive coverage not paid for and perhaps not even capable of being given.¹⁴¹ This is a classic case for restitution. Indeed, restitution is frequently recognized in the insurance context in situations that are strikingly parallel to the conditional defense case.¹⁴²

When the insurer exercises the right to defend conditionally, under what circumstances should the insurer be allowed reimbursement for advancing funds to settle the suit? If the insurer is taking the position, through the reimbursement request, that settlement is ultimately the policyholder's responsibility, fairness concerns may suggest that the policyholder be allowed some control over the ultimate obligation to be imposed. This may be characterized

¹⁴⁰ This is a common theme in contract and unjust enrichment law. FISCHER, *supra* note 58, at §53 (e).

¹⁴¹ For example, indemnification for injury intentionally inflicted by the policyholder may violate the public policy of the jurisdiction. See KEETON & WIDISS, *supra* note 34, §5.4(d); JERRY, *supra* note 1, § 63C.

¹⁴² Contribution is frequently allowed when the insurer has paid more than its proportionate share of an obligation to which other insurers are co-obligors. See, e.g., *Cincinnati Cos. v. W. Am. Ins. Co.*, 679 N.E.2d 91, 94 (Ill. Ct. App. 1997) (stating that "[t]he fact that an insurer undertakes the burden of a full settlement payment prior to a possible judgment does not mean that the insurer is a volunteer and the insurer, therefore, is not precluded from recovering contribution from other insurers liable for the same loss") (citation omitted); cf. *Md. Cas. Co. v. Bailey & Sons, Inc.*, 41 Cal. Rptr. 2d 519, 523-33 (Ct. App. 1995) (holding that statutory bar against contribution or indemnity when less than all persons responsible for a loss enter into a good faith settlement with the plaintiff did not operate to bar claim for contribution by paying insurer against other non-paying insurers). In *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997), the California Supreme Court relied exclusively on principles of unjust enrichment and restitution to accommodate the interests of the insurer and the policyholder when the insurer assumed the defense of both covered and uncovered claims because of the broad duty to defend rule applied in California. Douglas Richmond, *Reimbursing Insurers' Defense Costs: Restitution and Mixed Actions*, 35 SAN DIEGO L. REV. 457 (1998) (discussing *Buss* and its reliance on principles of unjust enrichment and restitution to allocate responsibility for defense costs when the insurer assumes the defense of the entire suit because one but not all of the claims are subject to a duty to defend). Compare *Shoshone First Bank v. Pac. Employers Ins. Co.*, 2 P.3d 510 (Wyo. 2000) (rejecting *Buss* allocation because the policyholder did not contractually agree to reimburse the insurer for defending uncovered claims).

as the "informed consent" model.¹⁴³ An alternative model would permit the insurer to settle for the policyholder's account, subject only to requirements of reasonableness and good faith. This model is analogous to the approach used in the insurer-breach cases discussed earlier. I would characterize this as the "reasonableness" model.

Neither the "informed consent" nor the "reasonableness" model is necessarily dictated by use of the consent or restitution theories. The availability of restitution is frequently conditioned on whether the person benefited was deprived of an opportunity to bargain for the benefit. This position is based on the understanding that any meaningful evaluation of whether one was deprived of an opportunity to bargain would require an after-the-fact analysis of whether one would have bargained, and to what resolution, if one had been aware of the relevant facts and circumstances at the time disclosure should have been made. This characterization would support use of the "informed consent" model even if reimbursement were based on restitution rather than consent.¹⁴⁴

The use of the "informed consent" model is stronger if reimbursement is based on consent. The consent theory is essentially based on the fiction of an agreement and is more properly seen as resting on an accommodation of the conflicting interests to the parties.¹⁴⁵ To speak of "implied" consent based on policyholder silence, as is often the case in this context, is to substitute a duty to speak for a right to contract. A duty to act necessarily presupposes a judicial assumption that it is reasonable to require policyholder action and to assign legal consequences to policyholder inaction. To require a party to speak suggests that the party's decision to speak or not to speak should be based on an informed awareness of the facts of the issue that party must address when and if the party speaks.

The idea that the party who will ultimately bear the cost of the settlement ought to have a meaningful role in a decision affecting its interests is appealing; nonetheless, on consideration of all the factors, a reasonableness test is superior to an informed consent test. Giving the party not in control of the defense a role in the settlement process will invariably complicate settlement negotiations. In order to give meaningful consent, the party not in control of the defense must have access to the same kind and quality of information the party in control possesses; otherwise, consent is hardly "informed." Even if the party

¹⁴³ *Golden Eagle Ins. Co. v. Foremost Ins. Co.*, 25 Cal. Rptr. 2d 242, 266 (Ct. App. 1993) (holding that conditionally defending insurer could not receive reimbursement for reasonable settlement of non-covered claim when insurer failed to give the policyholder the opportunity to reject the settlement); *L & S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987) (stating that because "it is the insured who may pay any judgment or settlement, . . . it is the insured who must make the ultimate choice regarding settlement"). Courts adopting this approach have intimated that if the policyholder refuses to consent to a reasonable settlement negotiated by the insurer, control of the defense may be transferred to the policyholder, *Golden Eagle Ins. Co.*, 25 Cal. Rptr. 2d at 242, or the insurer may seek court approval that would bind the policyholder, *Maryland Cas. Co. v. Imperial Contracting Co.*, 260 Cal. Rptr. 797, 804 (Ct. App. 1989).

¹⁴⁴ This probably accounts for the inclusion of a "demand" requirement when reimbursement is based on unjust enrichment rather than consent. See *supra* note 138.

¹⁴⁵ This fiction is not as counterintuitive as many legal fictions, but we should not forget that the consent theory is based on fiction, not fact.

in control is willing to share the information, the other party's risk threshold may differ substantially from that of the party in control of the defense. Involvement of a third party may also compromise the confidentiality of materials prepared by and for the party in control of the defense. Sharing privileged information with independent third parties is often deemed by courts to constitute a waiver or surrender of the privilege.¹⁴⁶

The simple fact that a completed settlement would require both insurer and policyholder assent before it was funded would necessarily make negotiation with the claimant more difficult. Even though the consent is limited to the value of the claim, the linkage between the consent and the ability to seek reimbursement by establishing that the settled claim is covered or not covered is evident. The weaker the coverage claim, the greater the incentive of the policyholder to withhold consent when the insurer is in control of the defense. The stronger the coverage claim, the greater the incentive of the insurer to withhold consent when the policyholder is in control. In each situation, the party with the power to consent may hope that by withholding consent it can exploit the desire of the party in control of the defense to settle with the claimant and then use the settling party's failure to secure consent as a defense to reimbursement. In each case, the party that anticipates it will ultimately bear the financial burden of the settlement often has an interest in delaying that day of reckoning.¹⁴⁷ Time is money and delay can be profitable given the use value of money and the uncertainty of litigation.

Conferring on a party the power to frustrate or complicate settlement raises the likelihood that in a significant number of cases that party will withhold consent, when consent should be given, in order to advance its own self-interest, *i.e.*, for strategic reasons separate from the reasonableness of the settlement. Courts, when called on to determine the validity and enforceability of the settlement, will invariably ask whether the consent was unreasonably withheld, which brings us back to a basic reasonableness test. Of course, the two approaches are not identical, else no one would ever bargain for consent provisions. The presence of a consent provision necessarily suggests more discretion on the part of the right-holder to give or withhold consent than under a pure reasonableness test. It also suggests a viewpoint (reasonable to the consent giver) that is different from that of the courts applying a general, contex-

¹⁴⁶ See *Weil v. Inv. Indicators, Research & Mgmt., Inc.*, 647 F.2d 18, 24 (9th Cir. 1981); PAUL R. RICE, ATTORNEY CLIENT PRIVILEGE IN THE UNITED STATES § 9.22 (1993) (discussing express and implied waivers). Whether the concept of waiver should be applied when information is shared between the policyholder and the insurer has produced inconsistent decisions. James Fischer, *The Attorney-Client Privilege Meets the Common Interest Arrangement: Protecting Confidences While Exchanging Information For Mutual Gain*, 16 REV. LITIG. 631 (1997).

¹⁴⁷ The policyholder may withhold its consent even though it believes the insurer will ultimately be responsible for the claim (*i.e.*, the claim is covered under the insurance contract) because it may not wish to encourage the insurer to pursue post-settlement litigation over coverage. Both the insurer and the policyholder may have different risk aversion thresholds regarding both the underlying liability claim and the coverage claim. To the extent the policyholder lacks confidence in the willingness of the insurer to be candid with the policyholder in evaluating the claim and in sharing information, the policyholder may prefer a neutral position regarding the settlement rather than accepting a position that reorients the litigation to one in which the policyholder must now assume an active role.

tual reasonableness standard (reasonable given all the facts and circumstances). Nonetheless, these differences do not warrant a preference for the consent model given the strategic disadvantages the consent model engenders.

Under the reasonableness model, the party in control makes a settlement decision based on its evaluation of the claim's expected value. That party may seek input or assent from the reimbursing party but, in the absence of a contract provision requiring notice, cooperation, assistance, or consent, the party in control should not be required to do so as a condition for securing reimbursement.

I do not want to suggest that the choice is easy, for it is not. For example, in the context of the conditionally defending insurer in control of the defense, requiring consent and vesting discretion whether to give consent in the policyholder is a plausible alternative. The insurer assumed some risk that it would not be able to protect fully its financial interests, as determined by the coverage provisions, when it elected to defend conditionally. In effect, the conditional defense permitted the insurer to protect its policy limits by retaining control of the defense, albeit at some risk to its coverage position regarding indemnity. The issue, however, is not simply plausibility, but the better of two possible resolutions. In this context, the "reasonableness" position is simply superior to the "informed consent" position given the context in which the positions must be judged.

The superiority of the "reasonableness" position may also be observed once we recognize that there is no reason to treat decisional errors by policyholders different from decisional errors by insurers. Let us stipulate that the conditionally defending insurer has erred and the claim is covered. Is the insurer's error meaningfully different from the converse case of a policyholder's error in refusing to consent because the policyholder erroneously believes the settlement is unreasonable, and results in an "excess settlement offer" judgment? It is the nature of a conditional defense that one of the parties will be wrong in its decision-making position and the consequences of error must be assigned. There is no *a priori* reason to favor the insurer or the policyholder based on their erroneous decisions, particularly when neither is in breach and thus "fault" cannot be used as a risk allocating factor. Resolution of the issue should be based on factors independent of the party's erroneous, but good faith, decision-making. If coverage considerations are not pertinent to allocating decisional responsibility for the settlement, there is no reason to give the party not in control of the defense a right to involve itself in the decision to settle.

Reasonable protection is provided by vesting control of defense authority in a conditionally defending insurer and requiring a showing of reasonableness and good faith in settlement to obtain reimbursement from a policyholder on an uncovered claim. The "reasonableness" requirement limits the ability of the insurer to escape a costly defense by simply throwing money at the claimant. The fact that the claimant overvalues the claim does not mean that the insurer can pay a premium to resolve the dispute. Reasonableness and good faith also mean that the insurer's claim valuation cannot include the cost of a continued defense if the insurer wishes to receive reimbursement. The insurer can, of course, decide to settle because the costs of defense are disproportionate to the expected value of the claim, but the insurer who does so settles for its own

account. When the insurer settles for more than the claim's reasonable expected value, the insurer should not be allowed to transfer that risk to the policyholder; otherwise, the insurer would be devaluing its promised defense.¹⁴⁸ Reasonableness in this setting thus focuses solely on the value of the claim without regard to the costs of litigation. This is distinct from the approach of a rational litigant who would not differentiate between defense costs and indemnity costs in deciding whether a settlement was preferable to continued litigation.

More important than the issue of claim value, however, is the reserved power of both the insurer and the policyholder to litigate claim coverage. Under the conditional defense model, the parties are not tied to the form of claim resolution expressed in the settlement; both are free to litigate *de novo* the coverage issue. From this perspective, denying the policyholder a right to participate in the settlement process seems to be the superior solution. If the claim is covered, the insurer settled for its own account; consequently, keeping the policyholder out of the process is consistent with the usual unconditional defense cases. If the claim is not covered, the policyholder does have exposure. Exposure is, however, proportionate to the likelihood that the claim is covered. Exposure increases as the probabilities increase that the claim is not covered. Proportionality provides two insights into the resolution of the dilemma.

First, we may note that as long as there is a realistic probability that the claim is covered, the insurer has a strong incentive to bargain effectively to reach a reasonable compromise of the claim. We may also note that the interests of the insurer and the policyholder are aligned. In the majority of cases, both wish to settle the claim for as little as possible. While the insurer and the policyholder may disagree as to where the case should settle on the range of reasonable outcomes, the fact remains that the disagreement is usually only one of degree. This alignment of interests, in the sense that the settlement be reasonable, helps assure that the policyholder's interests are protected because the insurer's self-interested acts are coherent with and thus will also further the policyholder's legitimate interests. In this sense, the policyholder's interests are represented by the insurer in negotiating settlement value with the claimant.¹⁴⁹

Second, as the interests of the insurer and the policyholder diverge because it becomes increasingly likely the claim is not covered, the justness of siting final responsibility for the payment of the claim with the policyholder increases even though the insurer is in control of the defense. This results not solely from the fact that the parties bargained that the policyholder rather than the insurer would assume the risk and economic costs of the non-covered claim, but also from the fact that a cause of the difficulty was the tender of the non-covered claim to the insurer. While insurance law has developed a set of rules that encourage insurers to assume their policyholders' defense in doubtful cases, we should hesitate before we craft rules that create overly generous incentives for policyholders to tender highly doubtful claims. The strengths of the coverage claim will be reflected in the insurer's approach to reimbursement.

¹⁴⁸ Whether the insurer or policyholder who settles for more than is reasonable should be denied any reimbursement versus partial reimbursement, *i.e.* the amount of a reasonable settlement, is not addressed by this paper.

¹⁴⁹ See *UNR Indus., Inc. v. Cont'l Cas. Co.*, 942 F.2d 1101, 1106 (7th Cir. 1991).

The insurer should be expected to seek reimbursement only in those cases where the claim of coverage was weak. Litigation with a policyholder is not costless. There must be a reasonable prospect of a satisfactory return on the investment in litigation with the policyholder, regarding reimbursement of money paid by the insurer to fund a settlement, for the investment to be worthwhile.

VII. UNSATISFACTORY ALTERNATIVES

There are several alternatives to the position that the obligation to fund a settlement, subject to reimbursement, should be aligned with the right to control the defense. One approach would be a model that assigns funding obligations to each party's exposure.¹⁵⁰ The right and power to settle would follow each party's actual exposure. The settlement interest is bifurcated into a covered exposure, which is assigned to the insurer, and a non-covered exposure, which is assigned to the policyholder. Each party may settle its own exposure but may not, without the consent of the other, settle the other's exposure for the other's account. Any settlement is essentially made at the risk that the coverage position of the settling party is incorrect.

There is a symmetry to this approach that is appealing; however, on full reflection I believe that the approach is unsupportable. First, the position is predicated on the assumption that control and settlement are divisible and independent. While I do not reject the position conceptually, I have argued in this paper that in actual practice the distinction is impossible to maintain.¹⁵¹

Second, the approach is based on certainty. It assumes that the coverage and non-coverage exposures are defined. In some cases this may be true, as, for example, in cases of excess limits exposures.¹⁵² In many other cases, however, the identification of the claim as covered or non-covered is more problematic, as, for example, in the alleged assault case discussed in Part IV.¹⁵³ If funding is deferred until coverage is determined, the ability to achieve claim closure will be impaired. The essential premise of this paper is that the public interest in achieving claim closure, the settlement of claims, and the payment of settlements to claimants often trumps the individual interests of either the policyholder or the insurer in deferring funding until the limits of coverage have

¹⁵⁰ Keeton, *supra* note 4; Barker, *supra* note 20.

¹⁵¹ See *supra* VI A.

¹⁵² Keeton presented the coverage/non-coverage model in the context of a policyholder who was faced with extracontractual liability due to the insurer's refusal to accept a "within limits" offer that would shield the policyholder from his exposure. Barker has argued, however, that the Keeton approach should be applied to the non-breach, non-standard cases generally:

My view, developed in my paper on *Insurer Control of Settlement* (an unpublished update of *Settling without the Insurer's consent*), is that partial coverage or uncertain coverage situations generate bifurcated settlement interests: the covered exposure and the non-covered exposure. Each interest may be unilaterally settled by the party bearing that exposure, if the plaintiff is willing to make such a partial settlement. Neither insurer nor insured may commit the other's funds. While that complicates settlement, I see no reason to inflate loss costs simply to facilitate settlements.

¹⁵³ See *supra* notes 86-91 and accompanying text.

been adjudicated. That public policy cannot be unlimited, however, else we would simply assign the funding obligation to the deeper pocket. The assignment of the funding obligation, with a right of reimbursement, to the party in control of the defense presents a workable balancing of the competing interests and complements the conditional defense model the courts have developed to reconcile the conflicts that may arise under the now separated promises to defend and to indemnify.

A different approach, suggested in *Golden Eagle Insurance Co. v. Foremost Insurance Co.*,¹⁵⁴ is that when the party in control is not settling for its own account, it must secure the consent of the ultimately responsible party to the settlement for the settlement to be binding on that party. If, however, the other party withholds its consent, the duty to defend may be transferred to that other party. This approach cannot be rejected out-of-hand for again there is a sense of symmetry and fairness to it. The problem, however, is that it creates an "implied right to consent" to a situation as to which the insurance contract is silent. That alone might not be a deciding factor, for this paper has recognized that the "unprovided for" features of the non-breach, non-standard cases might require the imposition of reasonable default rules. The larger difficulty with the "transfer of control" approach is that it is not really a solution. Transferring control of the defense is not a simple act. It will often require the consent of others, such as the trial court, and that consent may not be forthcoming. Moreover, there have been significant problems when consent provisions are expressly set forth in the insurance contract. It would be extremely difficult to provide a comprehensive default rule that would address the myriad possibilities that could arise when the "implied consent" term is activated.¹⁵⁵ In practice, it is no more efficient to decouple "consent" from "control" than it is to decouple "funding" from "control."

Lastly, the court in *Maryland Casualty Co. v. Imperial Contracting Co.*¹⁵⁶ suggested that a party could seek judicial approval of the settlement whenever it was settling for another's account and the other refused to consent. If the court approved, the settlement would bind the other. This approach has much to commend because it gives all affected parties an opportunity to present their claims and contentions before a neutral party for resolution. That benefit is, however, what makes its availability unlikely in practice. Courts have proven to be notoriously reluctant to allow the parties to the insurance contract to obtain judicial declarations of coverage while the underlying claim is being litigated.¹⁵⁷ Moreover, even if all parties agree to judicial resolution, which is

¹⁵⁴ See *supra* note 142.

¹⁵⁵ For example, a default rule would have to address what a transfer of control would entail? Would it include the duty to pay for defense costs? How should the costs of rejection be allocated if the claimant recovers an award larger than the rejected settlement? What happens if the party or person succeeding to control secures a defense verdict or an award lower than the rejected settlement? The range of possibilities the default rule would have to encompass suggests that it would be a poor approach to the problem. The rule would tend to be "ad hoc" and provide little guidance to the insurer or policyholder.

¹⁵⁶ *Supra* note 129.

¹⁵⁷ Pryor, *supra* note 36, at 24 (noting that "[m]ost courts disallow the simultaneous adjudication of the duty to defend on the basis of extrinsic facts when those facts overlap with facts at issue in the tort suit") (footnote omitted).

certainly not a given in light of the parties' competing interests and the hyper-adversarial manner of modern civil litigation, the size and scope of the "approval" litigation will likely duplicate the "reimbursement" litigation. All this proposal does is delay funding until the coverage litigation is concluded. If all the parties will agree to that delay, the *Maryland Casualty Co.* approach has merit, but in those cases no rule is needed because the parties' interests will encourage them to secure the desired efficient resolution. In other cases, postponing funding will likely lead to the frustration of settlement or the hobbling of settlements in order to increase the cost of an erroneous rejection. For example, to encourage an insurer to give its consent to a settlement, the claimant and the policyholder may propose an alternative, default settlement that will cost the insurer dearly if the insurer's non-coverage position is rejected by the court.¹⁵⁸ While I do not minimize the prospect that such alignments will occur naturally, I do not believe that such opportunistic alliances should be encouraged by legal rules. Rather, the legal regime should strive to create rules that are consistent with the natural interests of the parties to the conflict and advance their mutual interests.

VIII. CONCLUSION

Locating the duty to fund a settlement in the non-standard case, when the insurer has not agreed to provide an unconditional defense, requires a careful balancing of the rights and duties presented by the insurer's promise to defend and indemnify the policyholder. Each of the non-standard cases presents a different case for assigning the duty to fund settlements to either the insurer or the policyholder.

In the insurer-breach case, the courts have consistently limited the breaching insurer's ability to achieve a post-settlement/post-judgment position that would be superior to that of the unconditionally defending insurer. In the insurer-breach case, the issue of "funding" does not arise because the insurer's breach has taken the insurer out of play. The insurer's breach makes the funding issue meaningless because the insurer has clearly manifested its position that it has no obligations to the policyholder under the insurance contract insofar as the settled claim is concerned. The issue has always been whether the insurer-breach case should be a model for the other non-standard cases. I have argued in this paper that it should not. In the non-breach, non-standard cases, the duty to fund should follow actual control of the defense, with a right of reimbursement for reasonable settlement expenditures if it is determined that the party in control of the defense was not contractually obligated to absorb the indemnity cost of the claim.

When the policyholder or the insurer is in control pursuant to the insurance contract, the preferable view is also to use a reasonableness standard. The parties have specifically bargained for control of the defense. Whether settle-

¹⁵⁸ I do not want to suggest that this approach is improper. The alternative settlement may be much greater in amount reflecting the delay in and uncertainty of receipt of payment. On the other hand, the alternative settlement may be unreasonable, fraudulent, or collusive. This has proven to be a difficult area of the law for insurers. See *supra* notes 79-81 and accompanying text.

ment is seen as a part of the defense obligation or the indemnity obligation, the basic fact is that the contract provides for reimbursement when the policyholder contractually exercises control over the defense or reimbursement reflects a measured balancing of competing interests when the conditionally defending insurer controls the defense.

The more difficult case is presented by the conflict cases which are resolved by divesting the insurer of its right to control the defense and transferring it to the policyholder. This situation does not, however, really differ from the insurer control cases. Whatever impracticalities and inefficiencies attend to securing a policyholder's consent in the insurer control case also exist in the divestment of control cases when the policyholder has assumed control and the issue becomes insurer consent. Indeed, the existence of a coverage conflict may exacerbate the situation and make cooperation more difficult. In these cases, settlement funding obligations should be sited in the party in control of the defense. Reimbursement should be subject to the test whether the settlement was reasonable. This assumes, of course, that the claims settled are determined to be within coverage.¹⁵⁹ While this may result, in the policyholder in control cases, in some hollowing out of the benefits of coverage, that view is dependent on acceptance of the position that the insurer should bear the risk that it may be advancing funds to pay non-covered claims. It is only here that citing the funding requirement in the insurer not in control of the defense will have a real bite. If the coverage claim is well founded, it may be expected that claimants will accept "subject to" settlements and defer payment until the coverage issue is resolved. Conversely, if coverage is doubtful, the prospect increases that claimants and policyholders will see that their interests are jointly adverse to the insurer. Imposing a funding obligation on the insurer in this context raises obvious problems regarding the likelihood that the insurer's interest were represented in the settlement negotiations leading to claim valuation.

¹⁵⁹ If the settlement involves covered and non-covered claims, an allocation will be required. The forms of allocation are beyond the scope of this paper. The issue arises, however, with some frequency in Directors & Officers insurance coverage cases. In this area courts have used two formulas to allocate. First, the "relative liability exposure" approach which allocates as the test implies based on the relative exposure or proportionate fault as presented by the covered and non-covered claims, the assumption being that the relative exposure is reflected in the settlement. Second, the "larger settlement" test allocates based on the extent to which the non-covered claims increased, added to, or enhanced the loss. The allocation is thus determined by dividing the settlement between the basic loss and the enhanced loss, if any.