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Insurance Defense Costs: Allocation in Mixed Actions, Recoupment for Non-Covered Claims, Independent Counsel Fees

Maximizing Recovery or Limiting Exposure for Defense Costs

WEDNESDAY, JULY 26, 2017

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Today’s faculty features:

William T. Barker, Senior Counsel, Dentons, Chicago

Helen K. Michael, Partner, Kilpatrick Townsend & Stockton, Washington, D.C.

Sherilyn Pastor, Partner, McCarter & English, Newark, N.J.

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Recoupment of Noncovered Defense Costs and Settlement Payments

By William T. Barker
Dentons U.S., L.L.P.
233 South Wacker Drive, Suite 7800
Chicago IL 60611
312-876-8140
Fax 312-876-7934
william.barker @dentons.com

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William T. Barker is a Senior Counsel in the Chicago office of Dentons U.S.
LLP, with a nationwide practice representing insurers in complex litigation, including
matters relating to coverage, claims handling, sales practices, risk classification and
selection, agent relationships, and regulatory matters. He sometimes serves as an expert
witness on matters of insurance, professional responsibility and standard of care. He is a
co-author (with Ronald D. Kent) of INSURANCE BAD FAITH LITIGATION, SECOND
EDITION and (with Charles Silver) of PROFESSIONAL RESPONSIBILITIES OF INSURANCE
DEFENSE COUNSEL. He has been described as the leading lawyer-commentator on the
connections between procedure and insurance. See Charles Silver & Kent Syverud, The
Professional Responsibilities of Insurance Defense Lawyers, 45 DUKE L.J. 255, 257 n.4

Mr. Barker is a member of the American Law Institute and an Adviser to its
project on the Restatement of the Law of Liability Insurance. He is a Special Advisor to
the ABA Standing Committee on Ethics & Professional Responsibility. He is a past
Director of the Association of Professional Responsibility Lawyers. He is Co-Chair of
the Subcommittee on Ethics of the ABA Section of the Litigation Insurance Coverage
Litigation Committee and a Vice Chair of the ABA Tort Trial & Insurance Practice
Section ("TIPS") Committee on Insurance Coverage Litigation. He is TIPS Liaison to the
ABA Standing Committee on Lawyers’ Professional Liability, a past Chair of the TIPS
General Committee Board, the TIPS Ethics & Professionalism Committee, the TIPS
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§ 2.11 Insurer Recoupment of Noncovered Settlements and Defense Costs

[1] Overview

Liability insurers often provide or pay a policyholder’s defense before questions of coverage under the policy are resolved. A recurring issue is whether an insurer providing a defense under a reservation of rights (ROR) may recover defense costs from a policyholder if a court finds that the claim is not covered. Courts across the country have taken two distinctly different views. The decisions both allowing and disallowing reimbursement of defense costs base their rulings on considerations such as the perceived purpose of the duty to defend, principles of equity, and public policy concerns. The fundamental difference in the results reached by the two distinct lines of cases arises from how each court views and ultimately weighs these factors. This section reviews those decisions from both a policyholder and insurer perspective.

1 Compare


Courts allowing insurers to recoup defense costs from policyholders substantiate their rulings on three essential premises. First, these courts reason that an insurer did not bargain for (and perhaps did not receive premiums for) the obligation to defend uncovered claims. Therefore, regardless of when a court declares a claim uncovered, once that declaration is made, they find it would be contrary to the parties’ contract and expectations to require the insurer to have ever defended the claims.

A second and related rationale is one of unjust enrichment. That is, the courts find that policyholders receive an unfair benefit unless insurers are allowed to recoup defense costs expended on claims they should not have been defending in the first place.

The third line of reasoning posits that the ROR creates an implied contract, with new and adequate consideration, between the insurer and the policyholder with respect to uncovered claims. By the terms of this implied contract, the insurer obtains its right to seek reimbursement as a condition for paying for the policyholder’s defense of what the insurer regards as uncovered claims. The policyholder, by accepting a defense on these terms, is deemed to have accepted the implied contract. To establish the right to reimbursement under this approach, the insurer often must show that: (1) it specifically reserved the right to seek reimbursement from the policyholder; and (2) it provided the policyholder with adequate notice of this potential reimbursement. Some courts do not require the policyholder’s consent, or require consideration beyond the insurer’s offer and policyholder’s acceptance of the defense.

The various courts that have taken a pro-reimbursement stance give different weights to each of these rationales. The often cited case allowing reimbursement of defense costs to insurers

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2 This section presents a debate, originally published in NEW APPLEMAN CURRENT CRITICAL ISSUES IN INSURANCE LAW between Mr. Barker, presenting the insurer perspective, and Sherilyn Pastor, presenting the policyholder perspective. Ms. Pastor is a partner at McCarter & English, LLP, where she is Practice Group Leader of the firm’s Insurance Coverage & General Litigation Group and a member of the firm’s Executive Committee. Ms. Pastor counsels corporate policyholders and has recovered millions of dollars of insurance assets, by settlement or judgment, on behalf of policyholder clients.

3 See, e.g.,

Florida: Jim Black & Assocs., Inc. v. Transcontinental Ins. Co., 932 So. 2d 516, 518 (Fla. Dist. Ct. App. 2006);


4 See, e.g.,


is Buss v. Superior Court,\(^5\) concluding that insurers may obtain reimbursement of defense costs expended on claims that were not potentially covered, although the insurer bears the burden of proving which costs fell into that category.\(^6\) There a sports advertiser asserted 27 claims against Jerry Buss, owner of the Lakers and other Los Angeles-based sports teams.\(^7\) Of those 27 counts, both Buss and his insurer agreed that only one count was even potentially covered.\(^8\) Buss and his insurer entered into an express agreement providing that Buss would reimburse the insurer for any defense costs that were deemed not covered by a court decision.\(^9\) The Buss court, while recognizing that the duty to defend is broad and that an insurer cannot parse out uncovered claims from the underlying defense, explained:

As to claims that are at least potentially covered, the insurer gives, and the policyholder gets, just what they bargained for, namely, the mounting and funding of a defense. But as to the claims that are not, the insurer may give, and the policyholder may get, more than they agreed, depending on whether the defense of these claims necessitates any additional costs.\(^10\)

To effectuate the parties’ bargain, the Supreme Court of California concluded that the insurer is entitled to reimbursement of defense costs expended on claims that are not even potentially covered, even if they are incurred in a case with potentially covered claims.\(^11\) The court stated:

With regard to defense costs for these claims, the insurer has not been paid premiums by the [policyholder]. It did not bargain to bear these costs . . . . The insurer therefore has a right of reimbursement that is implied in law as quasi-contractual, whether or not it has one that is implied in fact in the policy as contractual.\(^12\)

The Buss court found that allowing the policyholder to retain the benefit of defense payments would unjustly enrich it.\(^13\) The Buss Court also found support for its decision in public policy:

Not only is it good law that the insurer may seek reimbursement for defense costs as to the claims that are not

\(^6\) 16 Cal. 4th at 53.
\(^7\) 16 Cal. 4th at 40–41.
\(^8\) 16 Cal. 4th at 42.
\(^9\) 16 Cal. 4th at 42.
\(^10\) 16 Cal. 4th at 49.
\(^11\) 16 Cal. 4th at 50–51.
\(^12\) 16 Cal. 4th at 51.
\(^13\) 16 Cal. 4th at 51–52.
even potentially covered, but it also makes good common sense. Without a right of reimbursement, an insurer might be tempted to refuse to defend an action in any part—especially an action with many claims that are not even potentially covered and only a few that are—lest the insurer give, and the policyholder get, more than they agreed. With such a right, the insurer would not be so tempted, knowing that, if defense of the claims that are not even potentially covered should necessitate any additional costs, it would be able to seek reimbursement. 14

In 2011, the United States District Court for the District of Arizona allowed reimbursement in *Phillips & Assoc., P.C. v. Navigators Ins. Co.* 15 A third party filed malpractice claims against the policyholders-law firms there, and the insurer accepted the defense under a ROR which expressly reserved a right to reimbursement and agreed with the policyholders’ request that the claims would be settled within policy limits. 16 The policyholders filed a declaratory action and, five days later, the insurer settled the underlying claim with the policyholders’ consent. 17 In the declaratory action, the insurer sought reimbursement for the amounts it spent on the underlying defense and the settlement if the underlying claim did not fall within coverage under the professional liability policy. 18 The court granted the insurer summary judgment, finding under the potentially applicable laws of California or Arizona, the insurer was entitled to reimbursement if it prevailed on the merits of the coverage dispute. 19

The *Phillips* policyholders had urged the court to adopt the Texas ruling in *Texas Ass’n of Counties Government Risk Management Pool v. Matagorda County*, 20 denying an insurer reimbursement. 21 The *Phillips* court distinguished *Matagorda*, however, finding significant that in *Matagorda* almost two years had passed between the time the policyholder filed its declaratory action and the time the insurer settled, whereas in *Phillips* only five days had elapsed. 22 According to the court, the *Phillips* insurer lacked the opportunity to resolve the coverage dispute before settling the underlying claim. 23 The court also implied it was irrelevant that the *Phillips*

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*California*: 16 Cal. 4th at 52–53. at 778; *accord*

*Ohio*: United Nat’l. Ins. Co. v. SST Fitness Corp., 309 F.3d 914 (6th Cir. 2002) (insurer’s offer of a defense with specific reservation of a right to recoup and a policyholder’s acceptance of the defense under those terms creates an implied-in-fact contract under Ohio law, allowing reimbursement for non-covered defense costs).


16 764 F. Supp. 2d at 1176.

17 764 F. Supp. 2d at 1175, 1177.

18 764 F. Supp. 2d at 1175.

19 764 F. Supp. 2d at 1175, 1178.


22 764 F. Supp. 2d at 1177.

23 764 F. Supp. 2d at 1177.
policyholders did not expressly consent to their insurer’s ROR, (the Matagorda County court had held express consent was required for an insurer to obtain a right to reimbursement) because Texas law was not controlling.\textsuperscript{24}

The policyholders also argued that Arizona’s public policy favoring the protection of policyholders supported the proposition that the Phillips insurer lost its right to seek reimbursement when it settled the underlying matter with the policyholders’ consent.\textsuperscript{25} The Phillips court rejected this application of Arizona law:

While this public policy certainly applies where there is uncertainty as to the insurance company’s defense of the insured or its willingness to settle on reasonable terms, different considerations control where the insured has received notice of the reservation of rights, has been provided a defense, and expressly consents to the settlement. If an insurer waived its coverage position simply by settling a claim for the insured, the insurer would be forced either to refuse to settle and face a bad faith claim, or to settle the lawsuit and lose its coverage defenses. The “resulting Catch-22 would force insurers to indemnify non-covered claims,” violating “basic notions of fairness.”\textsuperscript{26}

The Phillips court went on to say that offering reimbursement allows an insurer to protect against unjust enrichment of the policyholder and “advances significant public policy considerations.”\textsuperscript{27} According to the court, its approach to reimbursement “provides for the settlement of cases when coverage is uncertain, and thus ensures compensation of the injured party by placing ‘the risk that the insured may not be financially able to pay the injured party’s damages’ on the insurer.”\textsuperscript{28}

The Phillips court found significant the fact that the policyholders waived their right to select independent counsel for the defense when they failed to object both to the insurer controlling the defense and to the ROR issued seven months prior to settlement.\textsuperscript{29} Relying on Blue Ridge, the Phillips court explained that when a policyholder knows by a ROR that it may be held responsible for certain payments the insurer later makes “there is in fairness no need for the insurer to offer the defense to the insured.”\textsuperscript{30} The Phillips court concluded, “The Insureds were aware of this reservation well before settlement and did not disagree with [the insurer] on whether to accept settlement. [The insurer] therefore satisfied all prerequisites to seeking reimbursement

\textsuperscript{24}764 F. Supp. 2d, at 1177.  
\textsuperscript{25}764 F. Supp. 2d, at 1176.  
\textsuperscript{27}764 F. Supp. 2d, at 1176.  
\textsuperscript{28}764 F. Supp. 2d, at 1176 (quoting Blue Ridge, 25 Cal. 4th at 503.  
\textsuperscript{29}764 F. Supp. 2d, at 1177.  
\textsuperscript{30}764 F. Supp. 2d, at 1177.
under a reservation of rights.\footnote{764 F. Supp. 2d, at 1177 (internal citations omitted).}


Particularly in recent years, a number of courts have denied reimbursement of defense costs expended by an insurer on non-covered claims. Cases disallowing insurers’ claims for reimbursement find such claims to be inconsistent with the insurers’ broad duty to defend. They opine that an insurer is required to defend for as long as there is at least one potentially covered claim involved in a matter. They conclude that the duty to defend expires when the covered claims are eliminated by resolution or all of the claims are found to be uncovered; thus, the duty to defend is triggered and then expires prospectively, not retroactively.\footnote{See, e.g., Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am., 448 F.3d 252 (4th Cir. 2006) (Maryland law).}

These courts reject that an insurer has a right to reimbursement, finding their insurance contracts lack express reimbursement provisions.\footnote{See, e.g., Westchester Fire Ins. Co. v. Wallerich, 527 F. Supp. 2d 896, 908 (D. Minn. 2007), aff’d in part, rev’d in part, 563 F.3d 707 (8th Cir. 2009); Perdue Farms, 448 F.3d at 258–59; Shoshone 1st Bank v. Pacific Employers Ins. Co., 2 P.3d 510, 514 (Wyo. 2000).} Because the insurers often are the primary, if not sole, drafters of their insurance contracts, these courts conclude that insurers are not entitled to change or amend their insurance contracts by a ROR that incorporates a policyholder’s reimbursement obligation for uncovered defense costs.\footnote{See}

This line of cases finds that the policyholder is not unjustly enriched, as the insurer benefits from assuming control of and paying for the entire defense for claims that may not ultimately be covered. As the Third Circuit explained in Terra Nova Ins. Co. Ltd. v. 900 Bar, Inc.:\footnote{Terra Nova Ins. Co. Ltd. v. 900 Bar, Inc., 887 F.2d 1213, 1219–20 (3d Cir. 1989).}

Faced with uncertainty as to its duty to indemnify, an insurer offers a defense under a [reservation of rights (“ROR”)] to avoid the risks that an inept or lackadaisical defense of the underlying action may expose it to if it turns out there is a duty to indemnify. At the same time, the insurer wishes to preserve its right to contest the duty to indemnify if the defense is successful. Thus, such an offer is made at least as much for the insurer’s
own benefit as for the policyholder’s. If the insurer could recover defense costs, the policyholder would be required to pay for the insurer’s action in protecting itself against the estoppel to deny coverage that would be implied if it undertook the defense without a [ROR].

Moreover, since defending the entire case serves the insurer’s interests, the policyholder cannot reasonably be said to be unjustly enriched when it receives a defense for claims that are not potentially covered.36

The Supreme Court of Utah held, in United States Fidelity & Guaranty Co. v. United States Sports Specialty Ass’n, that an insurer may not seek restitution from its policyholder if its insurance policy does not provide for it.37 The court further found that an insurer’s claim of unjust enrichment cannot be the basis for a reimbursement claim where there exists an express contract (i.e., an insurance policy) on the subject matter of insurance rights and obligations.38

Policyholder USSSA was sued after a child was struck in the head with a bat and seriously injured.39 USF&G assumed USSSA’s defense under its $2 million liability policy. After trial, the jury issued a $6.1 million verdict against USSSA. When USSSA demanded that USF&G satisfy the entire judgment because it had, among other things, refused in bad faith to settle the claim within its policy limits, USF&G filed suit seeking declaration that it could not be compelled to pay more than its policy’s limits. The underlying lawsuit then proceeded to mediation, during which USF&G settled the claim for $4.8 million under a “unilateral reservation of rights” that purported to allow USF&G to seek reimbursement from USSSA for amounts above its policy limits. USF&G amended its coverage complaint to seek restitution from USSSA.40

The Utah Supreme Court held “a claim of unjust enrichment cannot arise where there is an express contract [i.e., an insurance policy] governing the ‘subject matter’ of the dispute.”41 The court reasoned that because unjust enrichment provides an equitable remedy where there is none at law, the doctrine may be invoked only when there is no express contract.42 Thus, for there to be a right to reimbursement from an insured, it “must be expressly provided in an insurance policy before it can be enforced.”43

The court further reasoned that because an insurer’s right to reimbursement from its policyholder affects the allocation of the risk between the parties, an insurer may not seek reimbursement or restitution by an extra-contractual claim of unjust enrichment.44 The court noted that allowing an insurer to seek reimbursement from its policyholder would distort the

38 2012 UT 3, ¶ 11 [270 P.3d at 468–69].
41 2012 UT 3, ¶ 11.
42 2012 UT 3, ¶ 13 (quoting TruGreen Cos. v. Mower Bros., Inc., 2008 UT 81, ¶ 18, 199 P.3d 929 (2008)).
43 2012 UT 3, ¶ 11.
bargained-for allocation of risk between the insurer and its policyholder, creating “a perverse manipulation of risk that has no place in our law.”

The court also rejected USF&G’s suggestion that the possibility of a threatened bad faith claim could serve as the basis for giving the insurer an extra-contractual right to restitution. The court reasoned that the implied covenant of good faith and fair dealing inherent in all insurance policies contemplates “that an insurer will diligently investigate the facts to enable it to determine whether a claim is valid, will fairly evaluate the claim, and will thereafter act promptly and reasonably in rejecting or settling the claim.” Because insurers deal regularly with risk analysis and allocation as part of their everyday business, they are in the best position to assess the viability of coverage disputes, including claims for bad faith. “If an insurer acts reasonably in its evaluation of a claim, it cannot be liable for violating the covenant [of good faith and fair dealing], even if the insurer denies a claim that it later determined to be covered by the policy,” and thus, “has no reason to fear a bad faith suit.”

In General Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co., the Illinois Supreme Court likewise rejected an insurer’s request for reimbursement. In doing so, the court rejected on public policy grounds the Buss analysis and the notion that an insurer’s ROR letter can unilaterally modify the parties’ contract:

As a matter of public policy, we cannot condone an arrangement where an insurer can unilaterally modify its contract, through a [ROR], to allow for reimbursement of defense costs in the event a court later finds that the insurer owes no duty to defend … [R]ecognizing such an implied agreement effectively places the policyholder in the position of making a Hobson’s choice between accepting the insurer’s additional conditions on its defense or losing its right to a defense from the insurer.

The General Agents court found significant the lack of an express provision in the insurance contract allowing the insurer to recoup defense costs. Absent such a provision, the court held that “an insurer cannot later attempt to amend the policy by including the right to reimbursement in its [ROR] letter.” It reasoned that a ROR letter merely protects the insurer’s right to assert existing defenses under the policy; it does not and should not create a new right, such as the right to reimbursement. The court concurred with the Third Circuit’s finding in Terra Nova that an insurer, by paying for or providing a defense, was serving its own interests as well as those of the policyholder. Given the benefit to the insurer, the court concluded that the

45 2012 UT 3, ¶ 17.
46 2012 UT 3, ¶ 20 (internal citations and quotation marks omitted).
49 215 Ill. 2d at 162–63.
50 215 Ill. 2d at 164.
51 215 Ill. 2d at 164.
52 215 Ill. 2d at 163–64.
The policyholder was not somehow unjustly enriched by receiving a full defense. Thus, the General Agents court required the insurer to defend until a court determined that the claims were not covered and rejected the insurer’s effort to re-define its duty to defend retroactively based on the outcome of its declaratory judgment action.

The Supreme Court of Pennsylvania weighed in on the issue in American & Foreign Insurance Co. v. Jerry’s Sport Center, Inc. The insureds were firearms wholesalers/distributors who had purchased liability policies that contained no express endorsement requiring them to reimburse the insurer for defense costs under any circumstances. When they were sued by various associations alleging that they had failed to distribute firearms reasonably and safely, and that their conduct constituted a public nuisance, the policyholders sought coverage. The insurer, which retained defense counsel for the policyholder under a ROR, purported to reserve its right to reimbursement of defense costs “ultimately determined not to be covered.” The insurer also filed a declaratory action arguing that it had no duty to defend or indemnify the insureds.

The Pennsylvania Supreme Court recognized other courts’ competing views on reimbursement issues and joined those holding that a policyholder need not reimburse an insurer for defense costs absent an express policy provision requiring otherwise. The Jerry’s Sport court observed that “it is the potential, rather than the certainty, of a claim falling within the insurance policy that triggers the insurer’s duty to defend.” It further explained that while a judgment finding no coverage relieves an insurer of a continuing obligation to defend a policyholder, it does not retroactively eliminate the insurer’s duty to defend during a period of uncertainty regarding the claim. The court, therefore, concluded that allowing for reimbursement, without a policy provision calling for it, would erode Pennsylvania law’s broad duty to defend by making it contingent on a court’s determination that a complaint alleged covered claims.

The court further noted that an insurer has no right to seek reimbursement based on a ROR letter, which merely reiterates the defenses and exclusions set forth in the policy and does not create a new contract. The court explained that allowing reimbursement based on a ROR, rather than on a policy provision, would permit an insurer to amend unilaterally and improperly its insurance contract with the policyholder. The Jerry’s Sport court also rejected the insurer’s

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53 215 Ill. 2d at 164.  
54  

Illinois: 215 Ill. 2d at 165–66; accord:

Maryland: Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am., 448 F.3d 252 (4th Cir. 2006);

Texas: Texas Ass’n of Counties Gov’t Risk Mgmt. Pool v. Matagorda County, 52 S.W.3d 128 (Tex. 2000).

56 606 Pa. at 591.  
57 606 Pa. at 590–92.  
58 606 Pa. at 609.  
59 606 Pa. at 611.  
60 606 Pa. at 613–14.  
62 606 Pa. at 615.
unjust enrichment argument, observing that such a theory envisions restitution where one has been unjustly enriched at the expense of another.\(^\text{63}\) That is not the case where, as here, the insurer had both a right and a duty to defend, and it benefited itself and the policyholder when it exercised that right and duty.\(^\text{64}\) The insurer benefited by, among other things, retaining control over the underlying defense and avoiding potential liability for bad faith in the event the claim was found to be covered.\(^\text{65}\)

The Pennsylvania Supreme Court described insurers’ options when presented with a claim:

> If [an insurer] believes there is no possibility of coverage, then it should deny its insured a defense because the insurer will never be liable for any settlement or judgment … .

> On the other hand, the insurer is uncertain about coverage, then it should provide a defense and seek declaratory judgment about coverage … . If the insurer is successful in the declaratory judgment action, it is relieved of the continuing obligation to defend. The court’s resolution of the question of coverage does not, however, retroactively eliminate the insurer’s duty to defend the insured during the period of uncertainty.\(^\text{66}\)

In *Excess Underwriters at Lloyds v. Franks Casing Crew Rental Tools, Inc.*\(^\text{67}\), ARCO/Vastar sued Frank’s Casing for collapse of a drilling platform in the Gulf of Mexico. Frank’s Casing had primary insurance with limits of $1 million and $10 million in excess insurance with Excess Underwriters. Excess Underwriters had no duty to defend. Coverage under Excess Underwriters’ policy for ARCO’s claims was then in dispute. Frank’s Casing faced possible liability substantially beyond its insurance limits.

During trial, Frank’s Casing received a demand that it contribute $7.5 million to settle ARCO’s claims. It was undisputed that, in relation to the liability and damages exposure in ARCO’s suit, this was a reasonable amount. The primary insurance had tendered its remaining limits, and Frank’s Casing demanded that Excess Underwriters contribute over $7 million to fund the remainder of the demand. Given the coverage dispute, Excess Underwriters offered to pay $5 million if Frank’s Casing would pay the remainder. When Frank’s Casing refused this offer, Excess Underwriters offered to pay the entire amount, subject to the right to recover it from Frank’s Casing if a court later found no coverage. Frank’s Casing refused to agree to any reimbursement obligation, but continued to demand that Excess Underwriters pay the amount necessary to settle. If Excess Underwriters refused to settle, Frank’s Casing threatened to hold it

\(^{\text{63}}\) 606 Pa. at 616.

\(^{\text{64}}\) 606 Pa. at 616.

\(^{\text{65}}\) 606 Pa. at 617.

\(^{\text{66}}\) 606 Pa. at 611 (emphasis added).

\(^{\text{67}}\) *Excess Underwriters at Lloyd’s v. Frank’s Casing Crew & Rental Tools, Inc.*, 246 S.W.3d 42, 44 (Tex. 2008).
responsible for any excess judgment that might result from failure to settle.\footnote{246 S.W.3d at 44–45.}

Excess Underwriters agreed to fund the settlement, but reserved the right to seek reimbursement if a court later found no coverage. Frank’s Casing consented to the settlement, but denied any reimbursement obligation. It later obtained a judgment that there was no coverage, and sought recoupment. The Texas courts nonetheless denied recoupment.\footnote{246 S.W.3d at 45.}

\section*{[4] Insurer Perspective\footnote{This subsection is by Mr. Barker and Ms. Pastor does not endorse any of the views stated.}}

\subsection*{[a] Overview}

Liability insurers are frequently called upon to defend suits against their insureds when it is questionable whether there is actually a duty to defend. The consequences of an unjustified refusal to defend can be quite unpleasant, so insurers often defend when they believe there is no duty to do so, but fear that a court might disagree. In such circumstances, they would like to be able to obtain reimbursement (sometimes called recoupment) of the amounts they expend on defense if they later establish that no defense was owed.

Similarly, an insurer defending a case with potential for a judgment in excess of policy limits is often faced with a demand that it settle for or within policy limits, even though it questions whether the claims that would be settled are actually covered by the insurance policy. But, in many jurisdictions, failure to settle might expose the insurer to liability for the full judgment, if that judgment turns out to be covered. (See § 2.03[6][c][ii][B]) The insurer would like to have the option of settling the claim against the insured and then, if it can establish lack of coverage, recoup the payment from the insured.

Courts are divided on these issues.\footnote{Compare, e.g.:

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\end{itemize}\

have to reject the conditional payment to avoid the condition, or does rejection of the condition force the insurer to choose between an unconditional payment and making no payment at all? For this reason, and because unjust enrichment analysis provides an answer that does not depend on agreement, that analysis seems preferable. But American courts and lawyers typically do not understand unjust enrichment law very well, so they tend to overlook or undervalue those arguments.

Before commencing the unjust enrichment analysis, let us put aside one issue: defense of so-called “mixed” suits, containing some claims subject to a duty to defend and some not subject to such a duty. In *Buss v. Superior Court* the California Supreme Court held that, in such cases, an insurer that properly reserves its rights, may recoup any defense costs attributable solely to the noncovered claims. But a dissent argued that the duty to defend is a duty to defend the entire lawsuit, so that the insured could not be unjustly enriched by the insurer’s discharge of such a duty. Ultimately, that question is one of interpreting the contract, but the dissent has the better of that argument. So, recoupment of defense costs should be even potentially available only when the insurer has no duty to defend at all.

[b] The Law of Unjust Enrichment Supports Recoupment

[i] The Absence of Coverage Establishes a Prima Facie Claim for Unjust Enrichment

In a case where there was no coverage at all, the insured was never entitled to any assistance from its insurer (even a defense) regarding the claims asserted against it. If there were a duty to defend, but the only plausible liability is not covered, then the insured had no right to any assistance in paying the resulting liability. If the insurer defends or pays to settle in such a case, the insured would receive a substantial benefit that was never due under the insurance contract. The insured would get that benefit purely because, at the time when a decision had to be made, there was uncertainty about what was due and that uncertainty made the insurer fearful of magnified liability if that assistance were not provided. But the premise of any recoupment claim is a later adjudication that the assistance was, in fact, not due.

As the Restatement (Third) of Restitution and Unjust Enrichment explains, these facts make out a prima facie claim for restitution of unjust enrichment:

Where a valid contract defines the scope of the parties’ respective performance obligations, a performance in excess of contractual requirements—neither gratuitous, nor pursuant to

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73 *See, e.g., Frank’s Casing*, 246 S.W.3d at 48. ("Given the parties’ explicit efforts to preserve their respective positions on the coverage/reimbursement question, it makes no more sense to conclude that Frank’s Casing impliedly agreed to reimburse the excess carriers than it would to say that the excess carriers impliedly agreed to waive their coverage position.").

74 *Buss, above.*

75 16 Cal. 4th at 62–66.

76 This issue is addressed by two Restatements, which state opposing rules. To distinguish, without the need to use the full name of each Restatement in every reference, the Restatement (Third) of Restitution and Unjust Enrichment will be referred to as “R3RUE,” and the Restatement of the Law of Liability Insurance will be referred to as “RLLI.”
compromise—results in the unjustified enrichment of the recipient and a prima facie claim in restitution . . . . “Restitution in such a case does not require that the contract be set aside; instead, it is a means of enforcing adherence to the contract, through ordering repayment of a sum to which the recipient was not entitled under the contract.”77

Specifically, R3RUE provides that

If one party to a contract [here the insured] demands from the other [the insurer] a performance that is not in fact due by the terms of their agreement, the party on whom the demand is made may make such performance under protest or with reservation of rights, preserving a claim in restitution to recover the value of the benefit conferred in excess of the recipient’s contractual entitlement.78

In such circumstances, R3RUE properly concludes that recoupment should be permitted.

In Frank’s Casing, the Texas Supreme Court, in rejecting recoupment, relied on the generally accepted rule that “‘[w]hen a valid agreement already addresses the matter, recovery under an equitable theory is generally inconsistent with the express agreement.’”79 The premise of this rule is that “[t]o recognize an equitable right to reimbursement would require us to ‘rewrite the parties’ contract [or] add to its language.’”80 If recognizing a recoupment claim would alter the allocation of benefits and burdens made by the contract, this point would have force. But, for precisely the reasons R3RUE points out, recognizing a claim for recoupment of benefits not due under the contract actually enforces the contract, rather than rewriting the contract. Indeed, the very case the Texas Supreme Court relied on for the quoted rule recognizes a widely-followed exception: “overpayments under a contract can be recovered under a theory of restitution of

77 RESTATEMENT (THIRD) OF RESTITUTION & UNJUST ENRICHMENT, § 35, cmt. a (2011).
78 R3RUE, § 35(1). But see Restatement of the Law of Liability Insurance, §§ 21, 25(2) (Prop. Final Dr. Mar. 28, 2017) (stating a more restrictive rule for recoupment by liability insurers), discussed in § 2.11[4][d][iv], below). In the context of recouping settlement costs (after the insured had demanded the insurer settle), the Sixth Circuit predicted that the Kentucky Supreme Court would adopt essentially this reasoning: “It would seem an unjust outcome for the insurer if this Court were to sanction [the] position that . . . [the] insured would be both getting the settlement at the time it preferred and having that settlement funded by the insurer when no coverage was afforded under the policy.” Travelers Prop. & Cas. Ins. Co. v. Hillerich & Bradsby Co., 598 F.3d 257, 269 (6th Cir. 2010) (KY law).
79 Frank’s Casing, 246 S.W.3d at 50, quoting Fortune Prod. Co. v. Conoco, Inc., 52 S.W.3d 671, 684 (Tex. 2000). While the quoted passage addresses equitable rules (which, strictly speaking, do not include the law of unjust enrichment), the point also applies to unjust enrichment claims: “[g]enerally speaking, when a valid, express contract covers the subject matter of the parties dispute, there can be no recovery under a quasi-contract theory.” Fortune Prod. Co., 52 S.W.3d at 684.
unjust enrichment.”

The same point disposes of the Illinois Supreme Court’s concern that it is unjust to put the insured to a “Hobson’s choice between accepting the insurer’s additional conditions or losing its right to a defense from the insurer.” The insured can preserve all of its rights by accepting a defense subject to a right of recoupment. If recoupment is ever found due, it will be because the insured never had any right to a defense. Being forced to reimburse benefits it was never entitled to is hardly unjust, so neither is being asked for an agreement to do so in return for the insurer advancing amounts it may not be obliged to pay.

Some commentators and courts have argued that an unjust enrichment claim is barred by common “supplementary payments” provisions in liability policies providing that “[w]e will pay, with respect to any claim or ‘suit’ we defend; 1. All expenses we incur.” The argument is that

[b]y promising that the insurer will bear all defense costs for claims and suits it defends, the supplementary payments clause … precludes an insurer’s claim for reimbursement … . Under the plain terms of the clause, if the insurer defends (whether it acted because its duty was clear or it thought that the question of coverage was close enough so that it would be dangerous to refuse to defend), it must bear those costs. Allowing the insurer to shift defense costs back to the insured through reimbursement would contravene the clause’s express promise that the insurer will pay them. Accordingly, contrary to what a reader may conclude from reviewing cases on both sides of the question, standard liability policies are not silent about allocation or recoupment. They expressly disclaim it.

But, if the insurer had no duty to defend, it equally had no duty to pay any defense expenses. A demand from the insured for a defense would be a demand for two performances, neither of which the insurer would have been obliged to provide, if there were in fact no duty to

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81 246 S.W.3d at 50 (emphasis added). As R3RUE indicates, the rule allowing recovery of contractual overpayments is generally accepted.
83 Angela R. Elbert & Stanley C. Nardoni, Buss Stop: A Policy Language Based Analysis, 13 CONN. INS. L.J. 61, 94–98 (2006);

Pennsylvania: Am. & Foreign Ins. Co. v. Jerry’s Sport Ctr., Inc., 606 Pa. 584, 611 (2010);
84 13 CONN. INS. L. J. at 96.
defend. Thus, there would be prima facie unjust enrichment, which would be recoverable if the conditions specified in R3RUE were satisfied. The supplementary payments clause simply spells out one of the implications of a duty to defend. It cannot reasonably be read as disclaiming a right of recoupment in cases where there was no duty to defend and the conditions specified in R3RUE were satisfied.

[ii] Mere Uncertainty About Existence of Coverage Does Not Create a Duty To Defend

The foregoing analysis presumes that the later determination that there is no duty to defend means that there was never a duty to defend. Some of the antirecoupment cases suggest that this is untrue, that there was a duty to defend until such time as the court determined that there was not. That suggestion is unsound, for reasons that will now be discussed.

This suggestion is particularly prominent in Jerry’s Sports Center. The court summarized the law on an insurer’s duty to defend as follows:

An insurer’s duty to defend is broader than its duty to indemnify. It is a distinct obligation, separate and apart from the insurer’s duty to provide coverage. An insurer is obligated to defend its insured if the factual allegations of the complaint on its face encompass an injury that is actually or potentially within the scope of the policy. As long as the complaint “might or might not” fall within the policy’s coverage, the insurance company is obliged to defend. Accordingly, it is the potential, rather than the certainty, of a claim falling within the insurance policy that triggers the insurer’s duty to defend.

The question of whether a claim against an insured is potentially covered is answered by comparing the four corners of the insurance contract to the four corners of the complaint. An insurer may not justifiably refuse to defend a claim against its insured unless it is clear from an examination of the allegations in the complaint and the language of the policy that the claim does not potentially come within the coverage of the policy. In making this determination, the “factual allegations of the underlying complaint against the insured are to be taken as true and liberally construed in favor of the insured.” Indeed, the duty to defend is not limited to meritorious actions; it even extends to actions that are “groundless, false, or fraudulent” as long as there exists the possibility that the allegations implicate coverage.85

Based on this exposition, the court agreed with the insured

that whether a complaint raises a claim against an insured that is potentially covered is a question to be answered by the insurer in the first instance, upon receiving notice of the complaint by the insured. Although the question of whether the

claim is covered (and therefore triggers the insurer’s duty to
defend) may be difficult, it is the insurer’s duty to make that
decision. Insurers are in the business of making this decision.
The insurer’s duty to defend exists until the claim is confined to
a recovery that the policy does not cover. Where a claim
potentially may become one which is within the scope of the
policy, the insurance company’s refusal to defend at the outset of
the controversy is a decision it makes at its own peril.\textsuperscript{86}

In the court’s view,

[i]f [the insurer] believes there is no possibility of
coverage, then it should deny its insured a defense because the
insurer will never be liable for any settlement or judgment. This
would allow the insured to control its own defense without
breaching its contractual obligation to be defended by the
insurer. If, on the other hand, the insurer is uncertain about
coverage, then it should provide a defense and seek declaratory
judgment about coverage.

In a declaratory judgment action to determine whether a
claim is covered, the court resolves the question of coverage.
The court’s role in the declaratory judgment action is to resolve
the question of coverage to eliminate uncertainty. If the insurer is
successful in the declaratory judgment action, it is relieved of the
continuing obligation to defend. The court’s resolution of the
question of coverage does not, however, retroactively eliminate
the insurer’s duty to defend the insured during the period of
uncertainty.\textsuperscript{87}

This discussion seems to make the existence of a duty to defend depend on the insurer’s
state of mind. If the insurer is confident that there is no possibility of coverage, and if the court
agrees, then there never would have been any potential for coverage and there would have been
no duty to defend. But if, on the same facts, another insurer believed that there was no duty to
defend but was uncertain whether a court would agree, that uncertainty would give rise to a duty
to defend. Apart from antirecoupment cases, there appears to be no support for the suggestion that
the duty to defend is subjective in this way. And that suggestion is inconsistent with the
contractual roots of the duty to defend, roots the Pennsylvania court has lost sight of, even as it
purports to rely on the contractual language.

The duty to defend is a contractual duty, so its scope depends on interpretation of the
contract. The language and logic of the contract dictate that existence of the duty must ordinarily
be determined from the allegations of the complaint. But courts often lose sight of both the logic
and the contract itself. This can lead them into error, as it did in \textit{Jerry’s Sports Center}, where the

\textsuperscript{86} 606 Pa. at 610–11 (citations omitted).
\textsuperscript{87} 606 Pa. at 611 (citation omitted).
court failed to understand the meaning of the “potential for coverage” rule and the way it derives from the contractual language. (See also § 2.03 above.)

This sort of error is not uncommon when courts deal with fact situations near the edges of the duty to defend. Understandably, they are accustomed to looking to prior cases construing the same standardized contractual provisions rather than analyzing those provisions anew in every case. This process leads to error when courts apply the general rules stated in prior cases without understanding the contractual logic that generated those rules. When the wording of the interpretive gloss is substituted for the contractual language, the meaning is inevitably distorted, especially where the court providing the gloss was concerned with a problem different from that before the court seeking to rely on that gloss. In extreme cases, courts may even forget that they are construing a contract rather than making common law that best suits judicial views of public policy.

Such courts apply the rule that an insurer must defend whenever there is the “potential for coverage” without regard for the roots of that rule in the insurance contract. They forget that “[t]he insurer’s duty to defend its insured arises from the undertaking … stated in the contract of insurance.” When the duty is broad, that is because the contract makes it broad. But courts must not extend the duty beyond what the contract promises.

The “potential for coverage” rule is rooted in the contract, but in a way imposing limits that courts often fail to grasp. Indeed, courts often show no appreciation for the relevance of the contractual language on the duty to defend, failing even to mention that the policy contained such language.

A liability insurance policy ordinarily devotes most of its coverage-defining terms to specifying who is insured and what liabilities an insured will be indemnified against, and on what conditions. The duty to defend is created by language promising to defend any suit against an insured alleging liabilities of the sort insured.

The “potential for coverage” rule derives from this language through a contractual construction explained by Judge Learned Hand in the seminal case of Lee v. Aetna Casualty & Surety Co. Indeed, the Pennsylvania court acknowledged in Jerry’s Sports Center that it was relying on that construction.

In Lee, Judge Hand reasoned that the insurer, having promised to defend, “has promised to relieve the insured of the burden of satisfying the tribunal where the suit is tried, that the claim as pleaded is ‘groundless.’” Consequently, “if the injured party states a claim, which, qua claim, is for an injury ‘covered’ by the policy … it is irrelevant that the insurer may get

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89 118 Ill. 2d. at 48–53.
90 Lee v. Aetna Casualty & Surety Co., 178 F.2d 750 (2d Cir. 1949).
91 Jerry’s Sport Cir., 606 Pa. at 609 (“As long as the complaint “might or might not” fall within the policy’s coverage, the insurance company is obliged to defend. Casper, 408 Pa. 426, 184 A.2d 247 (quoting Judge Learned Hand’s assertion in Lee v. Aetna Casualty & Surety Company, 178 F.2d 750, 752 (2d Cir. 1950))).”)
92 Lee, 178 F.2d at 752.
information from the insured, or from any one else, which indicates, or even demonstrates” that the allegations of a covered basis of liability are false. The duty to defend has not been discharged until the court entertaining those allegations has been convinced that no liability of a type covered by the policy exists.

This is the first aspect of the “potential for coverage” rule. “Potential for coverage” refers to the potential for indemnity coverage, and such a potential exists if the complaint asserts any claim that, if proven, the insurer would be obliged to indemnify against. It matters not if the claim is “groundless, false or fraudulent.” The insurer must protect the insured against the covered claim by successfully defending it or by paying or settling it.

Judge Hand found uncertainty about application of the duty to a suit involving allegations of both covered and noncovered grounds for the same purported liability, but he concluded that the uncertainty should be resolved in favor of the insured. This conclusion established another of the now entrenched doctrines governing the duty to defend with respect to such mixed claims: “if the plaintiff’s complaint against the insured alleged facts which would have supported a recovery covered by the policy, it was the duty of the defendant to undertake the defence, until it could confine the claim to a recovery that the policy did not cover.”

This is a second aspect of the “potential for coverage” rule: there is a potential for coverage (and a duty to defend) if any of the claims asserted would (if established) be covered, even if other claims are asserted for which there is no coverage.

The rule requiring defense of suits asserting mixed claims is supported by strong practical considerations where, as is the norm, the covered and noncovered claims arose out of the same incident. Defense of claims intertwined in that way usually must be conducted by a single chief counsel. So if the insurer is to defend the covered claims, no one else can be in a position to defend the others.

The Lee reasoning is universally applied, not only to mixed claims, but also to those where, due to the relatively unspecific nature of modern pleading, one cannot be sure whether the complaint asserts a covered claim. If there is doubt about what claims are asserted against the insured, and if at least one of the claims that might be asserted is one that is covered, it will be assumed that the complaint actually asserts that claim, which requires the insurer to defend.

Both where the scope of the complaint is uncertain and where the complaint asserts both

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93 178 F.2d at 751. An alternate statement of this point is that “an insurer cannot avoid the duty to defend merely by concluding, based on its own investigation, that the insured has done no wrong. The duty to defend does not evaporate simply because the insurer has decided that the insured will ultimately be exonerated ….” A-H Plating, Inc. v. American Nat’l Fire Ins. Co., 67 Cal. Rptr. 2d 113, 121 (Cal. Ct. App. 1997).

94 As the Texas Supreme Court put this point, “if GuideOne knows [the liability] allegations to be untrue, its duty is to establish such facts in defense of its insured.” GuideOne Elite Ins. Co. v. Fielder Road Baptist Church, 197 S.W.3d 305 (Tex. 2006) (emphasis added).

95 Lee, 178 F.2d at 753.

96 Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co., 439 Mass. 387, 394 (2003) (“[I]f the allegations of the complaint are ‘reasonably susceptible’ of an interpretation that they state or adumbrate a claim covered by the policy terms, the insurer must undertake the defense”).

See NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE, § 30.14[4][a].
covered and noncovered claims, “it [is] the duty of the [insurer] to undertake the defence, until it [can] confine the claim to a recovery that the policy did not cover.”

But the insurer “confines the claim” by defense activity, either by establishing that the covered claim is not asserted or by successfully disposing of that claim. Nothing in the traditional construction of the duty to defend depends on whether the insurer believes there is or might be coverage nor on whether a court has resolved any uncertainty about whether there is a duty to defend.

The Pennsylvania court in Jerry’s Sports Center, and other antirecoupment courts that rely on similar analysis have confused the “potential for coverage,” as defined in Lee and its progeny, with the risk that coverage will be found. Certainly, that perceived risk will sometimes induce an insurer to offer a defense under reservation when, in fact, there is no potential for coverage and no duty to defend. But there is no basis in the contract language to find a duty to defend based on the risk that coverage might be found if there is no actual potential for coverage that would create a duty to defend regardless of the perceived risk. So, this basis for antirecoupment decisions is unsound and ought not to be followed.

Moreover, under a rule which precludes recoupment of defense costs incurred prior to a declaration that there was never a duty to defend, insureds would have an incentive to “stave off a judicial determination regarding coverage” by seeking to stay the coverage action or, if a stay is denied, dragging it out as long as possible. This would magnify the windfall to the insured and would likely increase the cost of the coverage litigation.

[c] The Voluntary Payment Rule Does Not Defeat Recovery

[i] The Voluntary Payment Argument

Establishment of a prima facie claim for unjust enrichment is only the beginning of the unjust enrichment analysis. As the Texas Supreme Court and R3RUE had previously recognized, “[t]he restitution claim to recover a payment in excess of an underlying liability … meets an important limitation in the voluntary payment rule.” Under that rule, “‘money voluntarily paid on a claim of right, with full knowledge of all the facts, in the absence of fraud, deception, duress or compulsion, cannot be recovered back merely because the party at the time of payment was ignorant or mistook the law as to his liability.’” The insurers’ uncertainty about whether there was coverage for the liabilities asserted against the insureds in Midwest Sporting Goods and Frank’s Casing was an uncertainty about how the law would be applied to the known facts of those claims. So, the voluntary payment rule could apply, if its conditions were met.

The Texas court had recently explained the reason for the voluntary payment rule: “‘[a] party who pays a claim is deemed to have made his own decision that it is justly due. If he thinks otherwise, he should resist. He should not pay out his money, leading the other party to act as

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97 Lee v. Aetna Casualty & Surety Co., 178 F.2d 750, 753 (2d Cir. 1950).
99 BMG Direct Marketing, Inc. v. Peake, 178 S.W.3d 763, 768 (Tex. 2005) (quoting R3RUE, § 6, cmt. e (Tent. Dr. No. 1 2001)).
100 178 S.W.3d, quoting Pennell v. United Ins. Co., 243 S.W.2d 572, 576 (Tex. 1951). R3RUE rejects any distinction between mistakes of fact and mistakes of law. R3RUE, § 5, cmt. f. But that point is not critical here. The very existence of a reservation of rights shows that an insurer did not mistakenly believe in the existence of coverage, but rather recognized the existence of uncertainty on that point.
though the matter were closed, and then be in a position to change his mind and invoke the aid of the courts to get it back.” Other Texas courts had held that “the rule against recovery of voluntary payments is not applied rigidly where the reasons for the rule do not exist. In some cases the payor is allowed to recover the money if he clearly never intended to surrender his position.”

[ii] Payment Under Duress of Circumstances Does Not Preclude Recovery

Regardless of how rigidly the rule is enforced, the obligation to resist the claim before paying presupposes the ability to obtain a timely adjudication, before the payor is forced to risk irrecoverable harm if payment is refused. Thus, in rejecting a claim of duress in making payments not actually due under a contract, the Texas court had previously emphasized that “[a]ppellant certainly had ample time and opportunity to have had his day in court, before the business between him and appellee was closed by the last voluntary payment made by him. Not having complained until the late date at which this suit was brought, he cannot now be heard to complain.”

Where there has been a need to act before the payor could have his day in court and a risk of forfeiture if he failed to pay, courts have been willing to find sufficient circumstantial duress or compulsion to permit an action for restitution of contractual overpayments. It should be emphasized that circumstantial duress sufficient to permit recovery of contractual overpayments is generally not sufficient to support an unjust enrichment recovery when there is no preexisting obligation to provide the measure of what is just. So the rule urged here would have only narrow application.

In the context of contractual overpayments, a common example of circumstantial duress is a policyholder who has a life or disability insurance policy that grants a waiver of premium if the policyholder is totally disabled. If the policyholder claims to be disabled and the insurer disagrees, the policyholder faces a risk if he discontinues payment of premiums. Should a court find that the insurer was correct in denying the waiver, the policy will be forfeited for non-payment of premiums. But if payment of the premium would be deemed “voluntary” and non-recoverable, payment would forfeit the benefit of the waiver, through preventing forfeiture of the entire policy.

A few cases deny any right to recover premiums paid while disability was in dispute, taking a narrow view of what constitutes duress for purposes of the voluntary payment rule, and

101 178 S.W.3d at 768–69. Accord R3RUE §§ 6, cmts. d & e.
102 R.G. McClung Cotton Co. v. Cotton Concentration Co., 479 S.W.2d 733, 743 (Tex. Ct. Civ. App.—Texarkana 1972, writ ref’d n.r.e.); Spring Bank v. Mengden, 628 S.W.2d 130, 137 (Tex. Ct. App.—Houston [14th Dist.] 1981, writ ref’d n.r.e.) (quoting passage in text and following it to find issue of fact whether threat of foreclosure if payment not made rendered payment involuntary); West Texas State Bank v. Tri-Serv. Drilling Co., 339 S.W.2d 249 (Tex. Ct. Civ. App.—Eastland 1960, writ ref’d n.r.e.) (borrower permitted to recover amounts paid to bank despite knowledge that bank had wrongfully diverted large portion of original loan proceeds to unauthorized purpose).
104 Compare R3RUE, § 14 (defining “duress” permitting recovery in other circumstances as “coercive pressure that is wrongful as a matter of law”).
refusing to recognize the coercive effect of the risk of forfeiture.\textsuperscript{105} But the better reasoned cases permit recovery.\textsuperscript{106}

As the court explained in \textit{Still v. Equitable}, a key consideration is the lack of any means of resolving the dispute before the policyholder must decide whether to pay; duress for purposes of restitution "‘is a relative … term’ and … ‘where there is a necessity of acting at once, less may be considered to amount to such compulsion than in other cases.’"\textsuperscript{107} Applying this principle to the facts before it, the court concluded that,

> a person of ordinary business sense and prudence would have weighed the consequences with the same result as did the complainant. The compulsion under which the payments were made is apparent to any one who appreciates the value of a life insurance contract. The complainant was so situated that, if he failed to establish the permanency of his disability, he could not hope to obtain other insurance. Decision could not be postponed and time was of the essence of the matter. The payments were necessary to preserve valuable rights, and … we hold they were not voluntary.\textsuperscript{108}

This is approach is not unique to insurance cases. One of the principal authorities cited by \textit{Still} was \textit{Young v. Hoaglund}.\textsuperscript{109} This involved a disputed change in the composition of a corporate board. The old members of the board, disputing the legality of a meeting at which they had allegedly been ousted, levied an assessment on the stock of the company, and threatened to essentially “foreclose” the interests of those not paying by selling their shares. Plaintiff shareholders, being uncertain of whether the old directors retained the power to do this, paid (apparently without protest) and sought recovery. The new directors established, in another action, that they had properly displaced the old directors, so that the latter had had no power to levy the assessment. The California Supreme Court held that the shareholders were entitled to restitution of the payments.

The court held that “‘where, by reason of the peculiar facts a reasonably prudent man finds that in order to preserve his property or protect his business interests it is necessary to make a payment of money which he does not owe and which in equity and good conscience the receiver should not retain, he may recover it.’”\textsuperscript{110} Application of that principle was appropriate in \textit{Young}. If plaintiffs had refused to pay, they would have lost their stock if the assessment were

\textsuperscript{105} E.g. Featherstone v. Stonewall Life Ins. Co., 165 Miss. 164 (1933); Sebastianelli v. Prudential Ins. Co., 337 Pa. 466, 470 (1940) (collecting cases alleged to hold similarly). \textit{See also} Rosenfeld v. Boston Mut. Life Ins. Co., 222 Mass. 284, 290 (1915) (relying on hindsight determination that plaintiff need not have paid disputed premium because he was correct in believing it not due).


\textsuperscript{107} 165 Tenn. at 232.

\textsuperscript{108} 165 Tenn. at 234–35.

\textsuperscript{109} Young v. Hoaglund, 212 Cal. 426 (1931).

\textsuperscript{110} 212 Cal. at 431.
found to be legal. Assuming that the old directors were honest and sincere in their belief that they retained the power to assess, “it is hardly consistent for [them] to now claim that the stockholders knew that the assessment was illegal or even had reasonable grounds of believing it to be so, and therefore that the payment was voluntary on their part.”

A final notable case supporting restitution based on action necessary to prevent a risk of forfeiture is *Sunset Copper Co. v. Black*. There, a contract purchaser of real estate had gone into possession and made substantial improvements to the property. The seller then claimed to be entitled to interest on deferred payments of the purchase price, and threatened to forfeit the contract if the interest was not paid. The purchaser paid and sued to recover the payments. The court held that the threat of forfeiture was sufficient duress to allow recovery.

In his treatise on restitution, Professor Palmer agrees:

> in *Sunset Copper* the purchaser ran the risk of forfeiture only if he was wrong in his contention that the contract did not provide for interest. The legal uncertainty was an element in the coercion, as the court recognized. There was a good faith dispute in that case as to the proper interpretation of the contract, and the suggestion that he had an adequate judicial remedy is true only if he was correct in his contention. If he was not, the only safe means to protect himself from forfeiture was to pay the amount demanded. On the other hand, if the terms of the contract are clear, so that the vendor’s demand for an excess payment is made in bad faith, it ill becomes him to insist or for the court to hold that the purchaser should have used another remedy in resisting the unjust demand.

R3RUE also recognizes such circumstances as sufficient to permit a claim for restitution of contractual overpayments:

> Faced with the impossibility in many circumstances, of obtaining a determination of the parties rights and obligations before the claimed performance is due, and failing a compromise, a contracting party may be compelled by circumstances to render a performance to which the other is not entitled. Compulsion lies in the fact that the alternative courses of action—rejecting the other party’s demand before the requirements of the contract can be judicially determined—would expose the [payor] to a risk of loss or liability whose expected value exceeds the amount in controversy. In such circumstances, acceding to the recipient’s unjustified demand is

111 212 Cal. at 432. *Young* has not been extensively cited in the decades since its decision, but remains good law. *E.g.*, Chrysler Credit Corp. v. Ostly, 42 Cal. App. 3d 663, 675–76 (1974) (dictum, collecting and analyzing cases).

112 *Sunset Copper Co. v. Black*, 115 Wash. 132 (1921).

113 GEORGE PALMER, LAW OF RESTITUTION, at 318 (1978) (footnote omitted).
an action “in the reasonable protection of the [payor’s] own interests.”

Note that existence of duress of circumstances in no way assumes that the party making the demand is acting wrongfully. But the need for action at a time when the rights of the parties are unavoidably uncertain calls for a rule that allows the rights of both parties to be protected until adjudication can be obtained. If the demanding party has a right to the performance demanded, performance subject to a right of recoupment grants the full benefit of that right. If there was no right to that performance, an obligation to restore the benefits puts the demanding party in the same situation it would have been in had the lack of an obligation been known at the time of the demand.

The right to recovery might be lost if the recipient were lulled into the belief that the payor was surrendering its position. That is the reason why a payor that intends to seek recovery must protest the payment or reserve its rights to seek recovery. So, while the antirecoupment cases are right that a reservation of rights cannot create a right that did not exist to begin with, the right to be preserved need not be a contractual right. Such a reservation can preserve a right implied in law, such as the right to recover unjust enrichment. (Asserting a reservation of the right to seek recoupment does not, by itself, deny the insured any of the benefits of the policy, so it cannot constitute bad faith. (See § 5.09 below.)

The cases just discussed demonstrate that it is no bar to an unjust enrichment claim that the party conferring the benefit acted in part for that party’s own protection. Indeed, it is the need to act for the unjust enrichment plaintiff’s own protection before the parties’ rights can be adjudicated that avoids application of the voluntary payment defense.

It has been argued that:

Faced with uncertainty as to its duty to indemnify, an insurer offers a defense under reservation of rights to avoid the risks that an inept or lackadaisical defense of the underlying action may expose it to if it turns out there is a duty to indemnify. At the same time, the insurer wishes to preserve its right to contest the duty to indemnify if the defense is unsuccessful. Thus, such an offer is made at least as much for the insurer’s own benefit as for the insured’s. If the insurer could recover defense costs, the insured would be required to pay for the insurer’s action in protecting itself against the estoppel to deny coverage that would be implied if it undertook the defense

\textsuperscript{114} R3RUE, § 35, cmt. a.

\textsuperscript{115} R3RUE, § 35, cmt d (“When restitution is authorized under this Section, the basis of the claim is not the claimant’s statement to the defendant that he is performing ‘under protest.’ The reason for the restitution is that the claimant has performed under compulsion, conferring a benefit to which the defendant was not entitled under the contract. \footnote{The significance of such a claim of “protest” or “reservation of rights” is to repel any inference that the disputed performance is being rendered pursuant to compromise; and to give adequate notice to the recipient that the parties dispute remains to be adjusted, by litigation or otherwise.”).}

In fact, the insurer defends for the benefit of whichever party is entitled to the benefits of the defense under the terms of the insurance policy. If there was no duty to defend, there was also no duty to indemnify, and the insurer will neither have discharged any obligation by defending nor benefited from the defense. Rather, all the benefits will have accrued to the insured, who would not have been entitled to receive them at the insurer’s expense. Accordingly, the insured will have been unjustly enriched and should reimburse the insurer for the cost it incurred in defending. If, on the other hand, the insured was entitled to a defense, then it will have received that defense and will have no obligation to reimburse its cost.

[iii] The Circumstances in All of the Leading Cases Created Strong Pressure To Act Before the Parties’ Rights Could Have Been Adjudicated

[A] In Duty To Defend Cases, the Insurer Was Obligated To Defend or Face a Risk of Magnified Liability

In duty to defend cases, the insured had asked the insurer to defend. If the insurer were obligated to do so, refusal would be a breach. An insurer’s breach of the duty to defend subjects it to the risk that the insured will defend inadequately (or even default), despite which the insurer will be required to pay any resulting judgment within limits, if it were to be determined that the judgment were covered. (See § 1.04 above.) Moreover, a breach of the duty to defend would free the insured from policy conditions that forbid the insured to settle except at the insured’s own expense; a breaching insurer may be required to pay an inflated settlement, so long as it is nonfraudulent. (See §§ 4.04[1]–[2] below.) In Illinois and some other states, breach of the duty to defend could have exposed the insurer to an estoppel to deny indemnification. (See § 1.05[6] above.) So, a refusal to defend would have exposed any of the insurer to possibly inflated liability, if it turned out that it had a duty to defend.

[B] In Frank’s Casing, the Risk of Excess Exposure Required Immediate Action

In Texas, Excess Underwriters Risked Far Greater Liability From Refusing To Settle and Had No Clear Ability To Obtain Adjudication Before Deciding. In Frank’s Casing, if

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117 Terra Nova Ins. Co. v. 900 Bar, Inc., 887 F.2d 1213, 1219–20 (3d Cir. 1989), quoted in Midwest Sporting Goods, 215 Ill. 2d at 163, and cited in Am. & Foreign Ins. Co. v. Jerry’s Sport Ctr., Inc., 606 Pa. 584, 616 (2010). See also Nat’l Sur. Corp. v. Immunex Corp., 176 Wn. 2d 872, ¶ 30 (2013) (“Providing a defense benefits the insurer by giving it the ability to monitor the defense and better limit its exposure. When an insurer defends under a reservation of rights, it insulates itself from potential claims of breach and bad faith, which can lead to significant damages, including coverage by estoppel. In turn, the insured receives the benefit of a defense until a court declares none is owed. Conversely, when an insurer declines to defend altogether, it saves money on legal fees but assumes the risk it may have breached its duty to defend or committed bad faith. [¶] We reject National Surety’s view that an insurer can have the best of both options: protection from claims of bad faith or breach without any responsibility for the costs of defense if a court later determines there is no duty to defend. This “all reward, no risk” proposition renders the defense portion of a reservation of rights defense illusory. The insured receives no greater benefit than if its insurer had refused to defend outright.”).
Excess Underwriters had refused to settle, and if there had been coverage, faced the risk of much larger liability for the likely excess judgment under Texas law governing an insurer’s duty to settle. So refusal to pay apparently would have exposed Excess Underwriters “to a risk of loss or liability whose expected value exceeds the amount in controversy.” They claimed that they had no opportunity to obtain adjudication of their coverage obligations before they had to make a decision on the settlement. If they were right on those two points, that should have been sufficient to preclude a voluntary payment bar to their claim for contractual overpayments.

**It Was Reasonable for Excess Underwriters To Believe They Had No Opportunity for Early Adjudication of Coverage.** As it happens, both points were in some doubt under Texas law. As to the ability to have obtained adjudication before paying to settle the claim, Excess Underwriters received the demand in the middle of the trial of ARCO’s claims, when there was surely no time to have coverage adjudicated. But Frank’s Casing complained that Excess Underwriters failed to make a good faith effort to resolve the coverage issue expeditiously, once Excess Underwriters were notified of the action and reserved their rights to deny coverage. If there had been a real opportunity for Excess Underwriters to have done so, that might argue for denying relief from the voluntary payment rule.

But neither Frank’s Casing nor any of its amici made any attempt to show that Excess Underwriters could realistically have hoped to obtain a coverage ruling before ARCO’s claim against Frank’s Casing was resolved. The coverage issue usually litigated before the underlying liability is determined is the duty to defend, which depends only on the allegations of the complaint. But Excess Underwriters had no duty to defend, and the duty to indemnify depends on the actual facts, not the allegations of the complaint. As the Texas Supreme Court has pointed out, a ruling on coverage must be deferred if “coverage [will] turn on facts actually proven in the underlying lawsuit.” If this were such a case, and Frank’s Casing made no attempt to show otherwise, Excess Underwriters would not have been able to obtain a coverage adjudication before ARCO’s lawsuit was resolved.

Even if coverage did not depend on facts at issue in the underlying lawsuit, that alone would not have entitled Excess Underwriters to an early ruling on coverage. Until recently, Texas law was that the duty to indemnify could not be determined until the underlying liability was resolved. The Texas court made an exception for cases in which “the insurer has no duty to defend and the same reasons that negate the duty to defend likewise negate any possibility the insurer will ever have a duty to indemnify.” This is a narrow exception, and it appears to be the only circumstance in which the duty to indemnify can be adjudicated before the underlying action is resolved. It could not apply in Frank’s Casing, because Excess Underwriters had no duty to defend.

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119 GuideOne Elite Ins. Co. v. Fielder Road Baptist Church, 197 S.W.3d 305, 308 (Tex. 2006).
122 Firemen’s Ins. Co. v. Burch, 442 S.W.2d 331 (Tex. 1968).
123 Griffin, 955 S.W.2d at 84 (emphasis original).
124 Northfield Ins. Co. v. Loving Home Care, Inc., 363 F.3d 523, 529 (5th Cir. 2004) (treating Griffin exception as exclusive).
So it appears that Excess Underwriters had no way to obtain an early adjudication of the coverage issue. Certainly it would have been reasonable for them to think so, and that should have excused the failure to file such a suit there, even if the Texas Supreme Court were to have now held that an early adjudication would have been permissible. Nor did the court take the opportunity to minimize the future occasions when insurers might be forced to the sort of choice in \textit{Frank’s Casing}, by establishing for the future the ability to obtain an early coverage adjudication on issues other than the duty to defend.

The Texas rules that made it difficult to obtain an early adjudication on indemnity coverage are commonly followed elsewhere, so the same logic is generally applicable outside of Texas.

\textbf{Excess Underwriters Faced a Significant Risk of Liability for a Judgment Far in Excess of Policy Limits.} Even if there were no opportunity to obtain prompt adjudication, Excess Underwriters would not have needed to act immediately if the existence of reasonable doubts as to coverage would have excused it from any duty to settle. A minority of jurisdictions so hold.\textsuperscript{125} But Texas has not addressed the issue, and the majority rule is that:

\begin{quote}
the only permissible consideration in evaluating the reasonableness of the settlement offer becomes whether, in light of the victim’s injuries and the probable liability of the insured, and ultimate judgment is likely to exceed the amount of the settlement offer . . . [A] belief that the policy does not provide coverage[] should not affect a decision as to whether the settlement offer in question is a reasonable one.\textsuperscript{126}
\end{quote}

Under that rule, if the settlement offer is reasonable with respect to the insured’s probable liability and the prospective damages, the insurer turns down the offer at its peril. If coverage is found, the insurer will be liable for the excess judgment, no matter how reasonable its belief in noncoverage.

Unless and until a state adopts the minority rule on this, any insurer faced with a demand to settle a case with doubtful coverage is under real pressure to pay the amount demanded, lest it risk far greater liability.

\textbf{[C] Courts Should Follow Restatement (Third) of Restitution and Unjust Enrichment (“R3RUE”) § 35, Which Is Contrary To Midwest Sporting Goods, Jerry’s Sports Center, and Frank’s Casing}

The foregoing analysis shows that the facts in both \textit{all} of the cases under discussion fell within the rule of R3RUE § 35(1):

\begin{enumerate}
\item \textsuperscript{125} \textit{E.g.}, Mowry v. Badger State Mut. Cas. Co., 129 Wis. 2d 496, 514 (Wis. 1986). (\textit{See} § 2.03[6][c][iii][C] above.)
\item \textsuperscript{126} Johansen v. Calif. State Auto. Ass’n Inter-Ins. Bur., 15 Cal. 3d 9, 15 (1975). (\textit{See} § 2.03[6][c][iii][B] above.)
\end{enumerate}
If one party to a contract [here the insured] demands from the other [the insurer] a performance that is not in fact due by the terms of their agreement, the party on whom the demand is made may render such performance under protest or with reservation of rights, preserving a claim in restitution to recover the value of the benefit conferred in excess of the recipient’s contractual entitlement. 127

In fact, R3RUE expressly rejects Texas Association of Counties County Government Risk Management Pool v. Matagorda County, 128 which the Texas court followed in Frank’s Casing. 129 Other courts should follow R3RUE.

[d] There Is No Good Policy Reason To Deny Recoupment

[i] Recoupment Rights Will Not Affect Impecunious Insureds

Whether recoupment rights are good or bad for others, they will have no effect on impecunious insureds. Such insureds have no ability to reimburse the insurer, even if legally obligated to do so. No plaintiff would expend resources in suing an impecunious defendant who lacked insurance, and neither would an insurer. If either did, bankruptcy could discharge the unpayable debt.

[ii] Allowing Recoupment of Noncovered Defense Costs or Settlements Creates No Special Problems for Adequately Funded Insureds

An adequately funded defendant, faced with an uninsured lawsuit, would have to defend with its own resources. It is no worse off if an insurer advances the defense costs and recovers them later. If it fears that the insurer will be extravagant in defending, it has two protections. First, the insurer should be obliged to prove that any defense expenditures not specifically approved by the insured were reasonable. Second, if the insured wishes to do so, the insured could take part in the defense decisionmaking.

An insurer that defends under reservation, including a reservation of the right to recoup, is responsible for providing an adequate defense (unless the insured asks that certain expenditures be foregone). If it improperly skimps on the defense, it should be held liable for any resulting increase in the judgment.

[iii] Insureds Who Are Neither Wealthy Nor Impecunious Should Be Able To Protect Themselves By Settlements

If an insured that is arguably not entitled to a defense is capable of paying some, but not all, of its defense costs, it should be able to reach a settlement with the insurer for each party to bear a share of the defense costs that is reasonable in light of the uncertainty. Both insurer and

127 R3RUE, § 35(1).
129 R3RUE, § 35, Reporter’s Note c.
insured will need to take account of the insured’s limited ability to pay as well as the risk of an adjudication.

Similar considerations apply to recoupment of settlement costs. It is not clear whether Frank’s Casing had assets adequate to pay whatever judgment ARCO might obtain. But, if it did not, that could have been addressed by three-way bargaining. Excess Underwriters were prepared to pay two-thirds of the $7.5 million demand and drop the coverage issue, and the primary insurer would have contributed somewhat less than $500,000. In light of the eventual holding that there was no coverage, it seems likely that the $5 million offer was at least a fair estimate of the prospects in coverage litigation, and may have been generous. ARCO would likely have been willing to take a discount on its demand for an additional $2 million+, based on the value the claim would have had against an uninsured Frank’s Casing that could not have paid the full amount at issue. The fact that there was no such bargaining here suggests that the residual settlement value against an uninsured Frank’s Casing was no smaller than the $2 million+ that Frank’s Casing refused to pay. If Frank’s Casing did have that much ability to pay and still refused to bargain in hopes of forcing Excess Underwriters to bear the whole loss, then it would have no one but itself to blame for losing a favorable settlement opportunity. Either Excess Underwriters should have been allowed to recoup or it should have been decided that a reasonable dispute as to coverage would provide a defense against a failure to settle claim.

Insureds who have some ability to pay a judgment but not the ability to pay a full judgment will be able to protect themselves from unaffordable recoupment obligations by agreeing to participate in settlements that fairly reflect whatever coverage uncertainties may exist and also reflect their abilities to pay uninsured liabilities. That will relieve them of making Hobson’s choices between consenting to unaffordable settlements or exposing themselves to excess liability without the protection of the right to make failure to settle claims against insurers. Insurers and plaintiffs have every incentive to participate on a basis that fairly reflect the prospects if both liability and coverage are litigated.

The Restatement of the Law of Liability Insurance (“RLLI” or “Restatement”) Does Not Offer Good Reasons for the Contrary Rules Stated

[A] The Restatement

The Restatement of the Law of Liability Insurance states rules that preclude recoupment unless the insured agrees or the insurance policy contains language authorizing it:

Unless stated in the liability insurance policy or otherwise agreed to by the insured, a liability insurer may not seek recoupment of defense costs from the insured, even when it is subsequently determined that the insurer did not have a duty to defend or pay defense costs. 130

Unless otherwise stated in a liability insurance policy or agreed to by the insured, an insurer may not settle a legal action

and thereafter demand recoupment of the settlement amount from the insured on the grounds that the claim was not covered.\textsuperscript{131}

[B] Defense Costs

Departure by the Restatement of the Law of Liability Insurance ("RLLI") from the R3RUE rule is said to be justified by special considerations of insurance law. As to noncovered defense costs, the reasoning is largely a matter of supposed efficiency:

The default rule followed in this Section would likely result in lower overall litigation costs than would the alternative rule of recoupment. For example, in cases involving covered and noncovered causes of action, under a recoupment rule there would often have to be subsequent litigation over the question whether, or to what extent, the defense costs were incurred by the insurer in connection with noncovered causes of action. The rule followed in this Section entails no such secondary litigation. Moreover, because this rule is merely a default, if it turns out that the recoupment rule would be relatively easy to administer or that the costs justify the expense, insurers can incorporate an appropriate right to recoupment in their policies.\textsuperscript{132}

But the supposed inefficiency concerns only cases involving defense of so-called “mixed” suits, containing some claims subject to a duty to defend and some not subject to such a duty. That inefficiency is easily avoided by the following analysis:

In \textit{Buss v. Superior Court}, the California Supreme Court held that, in such cases, an insurer that properly reserves its rights, may recoup any defense costs attributable solely to the noncovered claims.\textsuperscript{133} But a dissent argued that the duty to defend is a duty to defend the entire lawsuit, so that the insured could not be unjustly enriched by the insurer’s discharge of such a duty.\textsuperscript{134} Ultimately, that question is one of interpreting the contract, but the dissent has the better of that argument. So, recoupment of defense costs should be even potentially available only when the insurer has no duty to defend at all. [See § 2.11[4][a], above.]

On that basis, the only issues to be litigated on the recoupment claim would be whether there was a duty to defend and whether the insurer properly reserved its right to recoup. The reservation of rights issues are unlikely to be costly to litigate, and existence of a duty to defend is not a secondary issue. So, with this limitation on the right to recoup, the efficiency argument collapses.

\textsuperscript{131} RLLI, § 25(2).
\textsuperscript{132} RLLI, § 21, cmt. \textit{a}.
\textsuperscript{134} 16 Cal. 4th at 62–66.
The efficiency argument fails to take account of ways in which the Restatement rule tends to create additional litigation costs and reward insureds who obstruct prompt determination of coverage issues:

Under its approach, insureds would be encouraged to engage in conduct that will drive up litigation costs. When insurers do defend claims while reserving rights, insureds would have an incentive to stave off a judicial determination regarding coverage if the per se anti-recoupment rule prevails. Policyholders could seek to stay any coverage action pending resolution of underlying claims. Indeed, if successful in doing so, they would in essence have created de facto defense coverage. When coverage litigation does proceed, insureds will be motivated to draw it out for as long as possible, such as through frivolous motions and needless discovery disputes, and they will have no reason to defend underlying claims efficiently since the bill will be paid by their insurer.\textsuperscript{135}

It is also argued in the RLLI that:

an insurer’s choice not to insert a recoupment provision in the contract acquires contractual significance \ldots Moreover, recognizing that the insurer is making the choice not to insert a recoupment provision in the policy brings the default rule adopted in this Section within the principle disfavoring the use of unjust enrichment when the parties are in a position to address the issues by contract. The issue of the right to recoup the costs of defending a noncovered claim is a known uncertainty that the insurer can address in the liability insurance contract, as is frequently the case in Directors’ and Officers’ Liability Insurance policies.\textsuperscript{136}


\textsuperscript{136} RLLI, § 21, cmt. a, (citation to R3RUE, § 2, cmt. omitted). The cited R3RUE comment states, in pertinent part, that

Contract is superior to restitution as a means of regulating voluntary transfers because it eliminates, or minimizes, the fundamental difficulty of valuation. Considerations of both justice and efficiency require that private transfers be made pursuant to contract whenever reasonably possible, and that the parties’ own definition of their respective obligations—assuming the validity of their agreement by all pertinent tests—take precedence over the obligations that the law would impose in the absence of agreement. Restitution is accordingly subordinate to contract as an organizing principle of
But the “rule disfavoring the use of unjust enrichment when the parties are in a position to address the issues by contract,” is a rule against having the benefits due to each party defined by a court when the parties could have done that in a contract. In the situation under consideration, the parties did define what is due to each under the insurance policy, and the benefits due to the insured did not include the defense that the insurer provided. As R3RUE specifically notes (and, as already pointed out), the rule disfavoring use of restitution does not apply in that context:

Where a valid contract defines the scope of the parties’ respective performance obligations, a performance in excess of contractual requirements—neither gratuitous, nor pursuant to compromise—results in the unjustified enrichment of the recipient and a prima facie claim in restitution … “Restitution in such a case does not require that the contract be set aside; instead, it is a means of enforcing adherence to the contract, through ordering repayment of a sum to which the recipient was not entitled under the contract.”

It is suggested in the RLLI that “an insurer’s choice not to insert a recoupment provision in the policy” indicates “that the hardship created by the lack of a right of recoupment is not as substantial as might appear in retrospect, when an insurer has defended a specific claim that it was not obligated to defend.” But the issue is not one of hardship to the insurer, but rather whether the insured has received a benefit to which it was not entitled. If so, it was unjustly enriched, and ought to be obliged to return the undeserved benefit.

Requiring a contractual grant of the right to recoup is supposedly advantageous because “it puts the legal basis of the insurer’s entitlement beyond dispute, and it specifies the contours of that entitlement in advance of a dispute, making it easier to evaluate for all parties concerned.” But there is no particular uncertainty in the application of the R3RUE rule. The only uncertainty is that of whether the R3RUE rule will be applied. The latter uncertainty could be as easily resolved by embracing the R3RUE rule as by rejecting it.

And, insofar as the Restatement relies on the argument that its rule allows insurers to contract around it, it “ignores the reality that many … recoupment disputes will arise in relation to policies that were issued before the Restatement was adopted, so that there was no opportunity to insert an express contractual term on this point in response to a proposed reversal of the law by the Restatement.”

private relationships, and the terms of an enforceable agreement normally displace any claim of unjust enrichment within their reach.

137 R3RUE, § 35, cmt. a.
138 RLLI, § 21, cmt. a.
139 RLLI, § 21, cmt. a.
After putting aside the arguments already disposed of, what remains is that “a default rule of no recoupment places the burden of contracting around the rule on the party best able to do so.” But that proves too much. The same could be said of a bank’s right to recover mistaken overpayments to its depositors. But the presumptive and the just rule (for both banks and insurers) is that, absent an applicable defense, nongratuitous contractual overpayments are recoverable, even if there is no contractual provision so stating.

Of course, a contract might include a provision waiving any right to recovery of nongratuitous overpayments or such a provision might be implied into the contract as a matter of insurance law. In that event, there would be no right of recoupment. But the normal unjust-enrichment rule is to the contrary, and the RLLI does not justify a special insurance law rule departing from the normal rule.

In evaluating the reasons stated in the RLLI, one should remember that payments subject to recoupment under the R3RUE rule are payments that the insured was never entitled to have the insurer make. A rule allowing recoupment of noncovered defense costs tends to provide insureds with all the benefits they are entitled to under the insurance policy, but no benefits they are not entitled to. The rule stated by the RLLI tends to expand the benefits to insureds beyond those they are entitled to under the insurance policy.

Of course, if that is to be the rule, insurers will build the cost into the premium and will, in the end, be adequately compensated for these extra costs. But do purchasers of insurance wish to pay those extra premiums? If they do not wish to pay for coverage for risks beyond the scope of the policy (perhaps because most of them are not subject to those risks), why should one expect that they wish to pay for the cost of noncovered defenses insurers will sometimes provide because of fear of the risks of denying a defense? Granted the extra cost of denying recoupment is not large as compared with the cost with a right of recoupment, and it has not been large enough to induce insurers to add reimbursement language to most policies. But even a small extra cost must be justified.

And here, that cost will have the effect of shifting defense costs associated with noncovered risks to policyholders who are not exposed to those risks (and so incur no defense costs for them) from policyholders who are subject to those risks and are pooled with those not subject to them. That grants an improper subsidy to those insureds who are subject to the excluded risks and who could reimburse the cost of defense were a right to recoupment recognized. Enrichment resulting from overperformance is no less unjust because it derives from premiums paid by other policyholders than it would be if the cost ultimately fell on the insurer. Nor is it less unjust because the amount is small than it would be if the amount were large.

The rule stated by the RLLI is justified in part as an information-forcing rule:

a default no-recoupment rule better informs insurance regulators of the coverage that the insurer intends to provide under the policy form, facilitating informed administrative review of insurers’ intent to seek recoupment, and, once the form

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141 RLLI, § 2i, cmt. a.
142 RLLI, § 24, cmt. a.
permitting recoupment is approved, better informs insurance purchasers of the more limited defense coverage provided by the policy.\(^\text{143}\)

The supposed information-forcing benefits to insureds are largely illusory. The RLLI itself recognizes (and insists that courts recognize) “the practical reality that ordinary people do not read, and cannot reasonably be expected to read, their insurance policies.”\(^\text{144}\) Even if a policy contained language authorizing recoupment of noncovered defense costs, and even if an insured read the policy, it is likely that few, if any, insureds would appreciate its meaning. Moreover, because it would address a contingency with low likelihood of occurring, and even lower likelihood of having practical significance to most insureds (see § 2.11[4][d][i], above), few if any of those insureds who read the policy and appreciated its meaning would regard it as significant in terms of their purchasing decision.

Thus, the supposed justification for the rule stated by § 21 of the RLLI comes down to forcing information to regulators who review policies. But, like the commercial policyholders likely to be affected, the commissioners do not have a strong need for information forcing, both because they are likely to have some understanding of this issue and because the affected policyholders are likely to be able to bring it to their attention if they do not have that understanding. Moreover, information forcing is less justified when the issue is not whether the benefits provided by the policy might be undercut, but rather whether policyholders are entitled to some benefit not provided by the policy, and whether policyholders not subject to such noncovered risks ought to be forced to finance the defense of those who are.

This is one of a number of instances in which the RLLI seeks to use ancillary rules to “stretch” the coverage provided by the express terms of the policy. Such stretching undermines the ability of insurers to define coverage and properly pool risks. As explained elsewhere:

> Insurance is a mechanism for the shifting and spreading of risk. The risks to be shifted and spread are defined by the policy’s coverage terms. Thus, auto policies cover ownership, maintenance, and use of autos, but not other risks to which insureds may be exposed. In contrast, homeowners’ policies cover only risks that do not arise from ownership, maintenance, and use of autos. Auto policies further specify which autos are covered, who is insured, and whether the coverage includes commercial use. Homeowners’ policies exclude coverage for business pursuits, while other types of policies are designed to cover business risks. Commercial general liability policies exclude coverage for liabilities to employees and professional liabilities, each of which is covered under a different type of insurance. Some risks (e.g., intentional injuries) are categorically excluded, and insurers attempt to limit some risks (e.g., pollution) to specialty policies.

\(^\text{143}\) RLLI, § 21, cmt. a.

\(^\text{144}\) RLLI, § 6, cmt. c (indicating that it is generally reasonable for insureds to rely on descriptions of policy coverage by insurers’ agents, even if contrary to the terms of the policy).
Defining the risks that insurance policies cover is essential for many purposes. Only by knowing which risks are covered can an insurer determine the level of risk an applicant presents, decide whether to extend coverage, assign the applicant to the proper risk pool, and price the coverage correctly. For example, a person presents one risk profile when driving a delivery truck around town and a different risk profile when driving a personal vehicle to the grocery store on weekends. Underwriting, pooling, and pricing decisions relating to coverage of the commercial vehicle and the personal vehicle would take account of different considerations.

But requiring insurers to defend claims, despite extrinsic evidence of facts (unrelated to the alleged liability) showing that there is no coverage forces insurers to incur defense costs despite the fact that the claim is outside the coverage of the applicable policy. Threatening insurers with forfeiture of coverage defenses if they erroneously refuse to defend pressures them to defend even when coverage appears quite unlikely, resulting in additional costs for defense of non-covered claims that would be unnecessary absent the threat of forfeiture. Other provisions of the [Restatement] not discussed [here] have similar effects.

The desirability of requiring insurers to shoulder uncovered risks is questionable. Non-covered costs paid by insurers will be shifted to a risk pool whose members generally do not share the non-covered risks that generate those costs. Competition should pressure insurers to package insurance coverages in ways that policyholders want, that is, in ways that maximize the joint wealth of policyholders and insurers as contracting parties. The proposed rules identified above repackage coverages in ways that markets have not selected. Consequently, they must be presumed to be wealth-reducing from the joint perspective of policyholders and insurers. To overcome this presumption, the [Restatement] would need to identify the market failures that have generated the deficiencies in insurance contracts that are thought to be corrected by the rules they propose. In other words, the [Restatement] should show that, in a perfect market, policyholders and insurers would bargain for the terms they propose on their own. Alternatively, they should show that there are sufficient reasons why protection of non-contracting parties justifies imposing terms that the contracting parties do not desire.

Put differently, we see the [Restatement] as giving primary importance to the desires of policyholders already facing lawsuits. We contend that the proper perspective is that of purchasers of insurance. Would such purchasers, given full information about the risks involved and the costs of insuring them, wish to pay those costs in order to shift those risks? In general, we believe that purchasers who do not expect to face
non-covered risks would not wish to pay higher premiums for
the benefit (or primary benefit) of those who do face such risks.
That belief is supported by the fact that insurance policies do not
already provide the sorts of protection that would be created by
the ancillary rules contained in the [Restatement].

No attempt is made in the [Restatement] to show, or
even argue, that insurance purchasers would find that the
benefits of the rules they propose outweigh their costs. Nor is
any attempt made to explain why such rules ought to be
mandated for the public good, even if insurance purchasers
would not willingly pay for them. In the absence of one or the
other showing, the ancillary rules stated by the [Restatement]
have not been adequately justified and ought not to be adopted
by lawmakers. 145

Professor George Priest makes related objections to the denial of recoupment on the
ground that it improperly impairs the segregation of insurance pools and thereby increases the
cost and reduces the availability of insurance coverage. 146

Absent strong reasons to adopt an unjust default rule, the law ought not to do so, and no
strong reason is provided by the RLLI.

[C] Settlement Costs

With respect to settlement costs, it is stated that

The strongest argument in favor of a no-reimbursement
default rule is less theoretical than practical: the current practice
in most liability insurance markets is for insurers not to seek
recoupment of the uncovered portion of settlements paid by
insurers. Rather, in the overwhelming majority of cases in which
the insurer agrees to settle a claim, insurers do not pursue
recoupment. Moreover, insurers have not developed a regular
practice of inserting settlement recoupment provisions in their
policies. Given that such provisions would be enforceable, the
absence of such provisions in policies can be taken as evidence
that the fairest and most efficient default rule and the one most
consistent with the parties’ reasonable expectations is one of no
recoupment. As mentioned, insurers and insureds are, of course,
free to alter this rule by clear contractual language. The fact that
insurers, who are in the best position to revise the policy

145 Charles Silver & William T. Barker, The Treatment of Insurers’ Defense-Related Responsibilities in the
146 George Priest, A Principled Approach to Insurance Law, John M. Olin Center for Studies in Law,
Economics, and Public Policy, Yale Law School, Research Paper No. 527 (“Principled Approach”), at 33,
37 (2015), to be published in George Mason L. Rev. (See § 1.05[6][d], above.)
language have so rarely attempted to include such a term in their policies suggests there is relatively little demand for policies with such terms.\textsuperscript{147}

It is recognized that the no-recoupment rule comes with some costs:

For one thing, it may mean that insurance premiums are somewhat higher than they would be under an alternative, pro-recoupment default rule. In addition, this no-recoupment rule may give insurers, in a legal action in which they believe they have a strong coverage defense, an incentive to resist settlement and litigate the action, thereby delaying any payment of the claim and preserving the possibility of shifting any resulting judgment to the insured. Of course, to follow this strategy the insurer would have to incur defense costs, and those costs may or may not be recoverable from the insured. Nevertheless, even taking the defense costs into account, it is clear that there will be some cases in which the no-recoupment rule would increase the risk to the insured of suffering a judgment that is wholly uninsured.\textsuperscript{148}

Insureds could avoid such risks by agreeing that particular settlement costs would be subject to a right of recoupment. But

\textsuperscript{[f]or this approach to fully protect insureds from the increased risk of uncovered judgments created by the no-reimbursement default rule, … insurers and insureds would need a degree of foresight that is unrealistic to expect in every case. For example, the insured would need to assess not only the likelihood of a loss in the underlying claim against the insured but also the likely size of the judgment if a loss were to occur, as well as the strength of the insurer’s grounds for contesting coverage.\textsuperscript{149}

On the other hand, if reimbursement is allowed,

insurers with grounds for contesting coverage will have a tendency to settle more cases than otherwise and to work less hard to keep settlements low. Thus, a pro-reimbursement rule would create a moral hazard on the part of insurers. From an insured’s perspective, a relevant question would be which prospect is more worrisome: the increased risk of uncovered trial

\textsuperscript{147}\textsuperscript{RLLI} § 25, cmt. c.
\textsuperscript{148}\textsuperscript{RLLI} § 25, cmt. c (citation omitted).
\textsuperscript{149}\textsuperscript{RLLI}, § 25, cmt. c.
judgments (resulting from a no-recoupment rule) or the increased risk of uncovered settlements (resulting from a pro-recoupment rule). This is an empirical question that has no easy answer.\textsuperscript{150}

In response to this last point, it must be remembered that an insurer that wishes to have a recoupment claim needs to notify the insured of the proposed settlement and the intent to seek recoupment. (\textit{See} § 2.11[4][c], \textit{above}.) If the insured regarded that settlement as excessive, the insured could request that it not be made. That request would free the insurer of the risk of liability for not making that settlement (\textit{see} § 2.05[2], \textit{above}), so there would be no basis for a recoupment claim were the insurer to proceed with the settlement. What the insured would not be able to do is to retain the threat of liability for not settling while refusing to bear the cost if the insurer settles and the settlement proves to be noncovered.

The insured could also defend any suit for recoupment by demanding that the insurer show that the amount was reasonable. Coupled with the right to veto a settlement perceived as excessive, this offers some protection against the supposed moral hazard. Moreover, there is little risk that insurers will be unduly generous in settling claims where reimbursement might be a possibility. Insurers have institutional interests in avoiding a reputation of paying more than appropriate amounts and the uncertainties of any recoupment claim seem likely to outweigh any savings in defense costs that might be obtained by an excessive settlement.

Returning to the “practical” argument, the supposed “overwhelming majority of cases in which … the insurers do not pursue reimbursement” is largely composed of cases in which the insured lacks the financial capability to provide significant reimbursement or in which the coverage argument is not strong enough to warrant litigating in light of the prospective recovery, especially where that litigation would need to determine the proper recoupment rule, as well as the existence of coverage. Insurer behavior in such cases casts no light on what rule is fair and efficient for insureds who do have the necessary financial capability, where the coverage issue is worth litigating, and where the recoupment rule is settled.

Nor do economic decisions based in part on the current existence of substantial anti-recoupment precedent cast light on whether other courts should endorse that precedent. Insurers do routinely attempt to lay the groundwork for possible recoupment claims by appropriate reservations of rights, and some courts and commentators treat acquiescence in such a reservation as an implied agreement to reimburse.\textsuperscript{151} Whether on this basis or that of unjust enrichment, insurers commonly negotiate for reimbursement, when the insured has the necessary financial capability, and at least sometimes receive it. We are not aware of any data on the frequency with which reimbursement is obtained or litigated in unreported cases. In these circumstances, there is insufficient information about insurer behavior (other than with regard to putting reimbursement language in policies) to support any conclusions about what is fair and efficient.

The argument thus reduces largely to the fact that insurers have not acted to insert reimbursement provisions in their policies. But the lack of a contractual right to recover says nothing about whether the law of unjust enrichment should provide such a right or whether the law of insurance ought to foreclose the ability of the law of unjust enrichment to do so. As

\begin{footnotesize}
\textsuperscript{150} RLLI, § 25, cmt. c.

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R3RUE demonstrates, restitution and unjust enrichment is an independent body of law, of equal dignity with contract and tort.

More importantly, even if insurers are content to deal with this issue by simply collecting additional premiums in lieu of reimbursement, that alone does not justify imposing such additional premiums on the policyholders called upon to pay them. The policyholders agree to pay a fair premium for protection against the risks covered by the policy. Risk pools are created based on exposure to common risks, as those risks are defined by the policy. Policyholders exposed to risks beyond those covered by the policy may be included in the risk pool precisely because the lack of coverage for those risks means that those not exposed to those risks will not be called upon to contribute to the costs resulting from those risks. Insofar as practicable, policyholders ought not to be charged for risks that are beyond the scope of the policies they purchase, because that forces policyholders not exposed to such risks to subsidize those who are.

[5] Policyholder Perspective

[a] Overview

In essence, an insurer’s claim for reimbursement of defense costs is an attempt to have the court “rewrite” the insurance contract to expand the rights of the insurer at the expense of the policyholder. The insurers admit, as they must, that the terms of the typical insurance policy do not include any express reimbursement provisions; instead, insurers ask courts to imply such provisions or seek to obtain the same result through the improper application of equitable principles, such as unjust enrichment. Courts should not, however, write a better policy for the insurance company than it chose to write for itself.

Under the insurance contract, the insurer is obligated to defend the insured with respect to potentially covered claims. If the insurer is certain a claim is not covered, the insurer can deny coverage. However, if the insurer defends a claim, the insurer is, at the very least, tacitly admitting that the claim is potentially covered and the insurer must defend that claim. And while the insurer runs the risk of a breach of contract or a bad faith claim if it wrongfully denies coverage, that is simply part of the risk the insurer assumes when writing its policies and not a cause for rewriting the contract to provide it with a right to recoup defense costs. If the insurer that wrote the policy cannot determine whether a claim is covered, the insurer cannot shift the risk of that uncertainty onto the policyholder by requiring reimbursement from the policyholder should a court later find the claim not covered.

Insurers will often attempt to provide themselves with a right to recoupment through reservation of rights letters, but the courts should not countenance the insurer’s attempts to avoid its contractual obligations in this way. A reservation of rights letter can only “reserve” those rights an insurer already possesses under its existing contracts with an insured; it cannot create a new contract, unilaterally and without consideration or the consent of the policyholder. Insurers are already in a superior bargaining position relative to policyholders; insurance policies are contracts of adhesions and the insurer generally is in the better bargaining position. To allow an insurer to modify the policy it wrote through a reservation of rights letter, after the policyholder is already exposed to a claim, is an improper transfer of the risk of defending potentially covered claims back onto the policyholder.

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152 This subsection is by Ms. Pastor and Mr. Barker does not endorse any of the views stated.
Moreover, allowing the insurer to modify its policy after the policyholder has already suffered a loss is clearly contrary to the policyholder’s reasonable expectation of coverage. The policyholder reasonably expects that its liability policy will protect it from litigation of claims, both covered and potentially covered. If the insurer is allowed to seek reimbursement from the insured, the litigation protection evaporates and the policyholder is left with something more akin to an excess policy that only reimburses ultimate net loss, but offers no duty to defend. This is not what the policyholder reasonably expected upon the purchase of its insurance policy. Thus, once the insurer defends a claim, the insurer must continue that defense (without reimbursement) until a court rules the claim is not covered.

Despite insurer arguments to the contrary, the law of unjust enrichment cannot provide that recoupment relief the insurer failed to write into its own policies. Because the policy requires the insurer to defend potentially covered claims, the policyholder whose potentially covered claims are defended by an insurer has not received any unjust enrichment—rather he has received the benefits of the insurance policy he purchased. This is not an unfair result for the insurers as they have the ability to write reimbursement provisions into their policies but choose not to do so. They also may account in their rate structure (if they do not already) for the possibility that they may occasionally pay uncovered claims.

Moreover, claims that the insurer is somehow under duress when it defends a potentially covered claim are without foundation. The possibility of defending a potentially covered claim certainly is foreseeable by the insurer, and the fact that an insurer may be subject to breach of contract and bad faith claims for not defending is not a sufficient reason. Any party to a contract faces the potential for breach of contract and bad faith claims if it does not live up to its agreement and this should not entitle the insurer to some sort of equitable relief from performing under the policy.

Finally, even if the insurers were correct that the policy does not require them to defend potentially covered claims, once an insurer has undertaken the defense of a claim, the insurer clearly has voluntarily paid an obligation it did not believe it had. Voluntary payments generally are not recoverable under the law, and insurers should be no exception.

For these reasons, the emerging trend among courts of various jurisdictions is a move towards denying insurers their claims for reimbursement of defense costs. Quite simply, it is what the policy requires; the insurers have not provided any persuasive reasons why the traditional rules of insurance contract interpretation should be discarded here.


Insurers’ reimbursement theories ignore that the insurance policy is an express contract on the subject matter of insurance. It contains provisions on the duty to defend, and it contains an integration clause. As to an insurer’s right and duty to defend claims, the policy typically provides:

We will pay those sums that the insured becomes legally obligated to pay as damages because of “bodily injury” or “property damage” to which this insurance applies. We will have the right and duty to defend the insured against any “suit” seeking those damages. However, we will have no duty to
defend the insured against any “suit” seeking damages for “bodily injury” or “property damage” to which this insurance does not apply. We may, at our discretion, investigate any “occurrence” and settle any claim or “suit” that may result.  

Moreover, and more importantly, the insurance policy provides:

This policy contains all the agreements between you and us concerning the insurance afforded . . . . This policy’s terms can be amended or waived only by endorsement issued by us and made a part of this policy.  

Nowhere in these integrated contractual terms is there any provision by which the insurer can seek reimbursement of defense costs. In fact, the insurers admit as much, which is why they do not argue that their contracts allow for reimbursement, but rather that they have a right to it by virtue of some implied contract or equitable theory. But as discussed below, insurers have no right to recoupment under implied contract or equitable theories.  

That the insurers have not included express reimbursement provisions should end the discussion because courts cannot and should not “write” better contacts for the parties. The lack of a reimbursement provision is not mere oversight, but reflects a conscious decision by the insurer. Insurers know how to draft reimbursement provisions and include such provisions in certain types of policies. Indeed, many directors and officers liability insurance policies contain provisions requiring the insureds to repay defense costs if a court decides that any part of them were not covered:

[I]t shall be the duty of the Insureds and not the duty of the Insurer to defend any Claim . . . . Subject to [the allocation provision] of this Policy, the Insurer shall advance on behalf of the Insureds Defense Costs which the Insured Persons . . . have incurred in connection with Claims made against them, prior to disposition of such Claims, provided that to the extent it is finally established that any such Defense Costs are not covered under this Policy, the Insureds . . . agree to repay the Insurer such Defense Costs.

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155 Insurers do not market their insurance products on the basis that they are somehow incomplete, and can be supplemented by other terms. To the contrary, insurers argue that absent written endorsement approved by them offered changes are ineffective.
156 Whether a policy provision providing the insurer with a right of reimbursement is enforceable in an adhesion contract setting remains an issue for the courts. But if it is not enforceable as an express contractual provision, it certainly cannot exist as an implied contract provision or equitable remedy.
To the extent an insurer wants such a provision, it should be bargained for by the insurer before its insurance contract is sold, not “implied” after a loss occurs and when a policyholder is faced with a third party’s liability claim.

When a policyholder purchases liability insurance, one of the principal benefits it expects to acquire is the right to have the insurer defend covered and potentially covered claims brought against the policyholder. Since Judge Learned Hand first espoused on it over 60 years ago in Lee v. Aetna Casualty & Surety Co., the duty to defend has been woven into the fabric of modern insurance law. Where a policy contains a defense obligation, the policy dictates the insurer’s obligation to defend any claim that potentially falls within the scope of coverage under that policy. The duty to defend is not contingent on the insured’s ultimately being found liable or on a court ruling the claim is covered by the policy’s indemnity provision; an insurer must provide a defense to potentially covered claims even if the claims are groundless, frivolous, illogical, false or fraudulent. Where a lawsuit involves multiple claims, the duty to defend applies as long as at least one of the claims alleged against the insured are potentially covered, and persists until all potentially covered claims are eliminated. Thus, consistent with existing and well-defined insurance law, an insurer’s defense obligations are broadly defined, and resultanty, broadly construed.

Accordingly, courts that reject reimbursement offer a view consistent with the parties’ bargain, their contract, and an insurer’s duty to defend. The broad duty to defend all claims as long as one is potentially covered is essentially gutted if the policyholder must later reimburse the costs of the defense. Policyholders purchase policies with defense obligations to protect them against litigation risks and uncertainty. That protection, and bargained-for risk transfer, is not meaningful if it can be revoked unilaterally and retroactively by an insurer.

It is beyond dispute that if a claim is covered, the insurer must accept its coverage.

158 E.g.,

California: Buss v. Superior Court, 16 Cal. 4th 35, 45–47 (1997);

159 E.g.,


New Jersey: Voorhees, 607 A.2d at 1259;

160 See, e.g.,

California: Buss, 16 Cal. 4th at 48;
Illinois: Gen. Agents, 215 Ill. 2d at 155;
obligations, including its defense obligations, but if a claim is not covered, the insurer may (if and as appropriate) deny coverage and advise the policyholder of the basis for its non-coverage position. But what about claims that are not clearly covered or not covered? Where the facts of the claim are not sufficiently developed or the contract the insurer drafted is not sufficiently clear such that the insurer is confident how a court will interpret it as a matter of law, the insurer’s own uncertainty evidences that there is the potential for coverage and hence a duty to defend. It is not that the insurer’s state of mind that somehow creates coverage (as insurers suggest); rather it is the insurer’s own equivocation, and tacit admission that its non-coverage position may not be correct, that demonstrates a claim is potentially covered and triggers the duty to defend.

Insurers may attempt to relieve themselves of the obligation to defend potentially covered claims by citing the policy provision that an insurer has no obligation to defend and indemnify suits “to which this insurance does not apply.” But this provision only allows an insurer to deny coverage if it concludes that a claim is not even potentially covered by its insurance policy. When an insurer elects to defend—because the facts or their contracts are sufficiently unclear—then it admits the potential for coverage and is obligated to defend at its, not its policyholder’s, expense.

When a claim is potentially covered and/or there is any uncertainty or a dispute regarding coverage, the insurer may (and in some states must) either: (1) defend the suit; (2) defend the suit under a reservation of rights; or (3) defend the suit while seeking a timely declaratory judgment of no coverage. The benefit to this approach is that an insurer has the ability to insulate itself from breach of contract claims and any bad-faith damages. To obtain this benefit, however, the insurer must continue to defend until the court issues a ruling finding no coverage. Another approach some insurers take when faced with a potentially covered claim is to deny the claim without providing a defense. Both approaches entail risks to the insurer. Under the first approach, the insurer runs the risk that it defended claims that ultimately were declared not covered. Under the second approach, the insurer runs the risk that the claim is later determined to be covered, in which case the insured breached its contract and, depending on the circumstances, may be subject to bad faith.

Contrary to insurers’ claims, there is nothing inappropriate under the law or the insurance

162 If the insurer fails to take one of these three steps and is later found to have had a duty to defend, the insurer then may be estopped from raising any policy defenses to coverage. See

Illinois: Ehlco Liquidating Trust, 186 Ill. 2d at 150–51. Coverage by estoppel prevents an insurer who has acted in bad faith from denying coverage even if it turns out there was no coverage under the policy. It also may require the insurer to pay all damages regardless of policy limits. Coverage by estoppel therefore is a remedy for, and to some extent, a deterrent against, some acts of bad faith. See, e.g.,

contract with the insurer bearing this risk. Insurers are in the business of insurance and assumption of risk, and by and large are the primary (if not sole) drafters of their contracts. Thus, if the insurer cannot determine the scope of its own contract, the law and equities do not favor shifting the burden of that uncertainty to the insured, whose very purpose in buying insurance is to insulate itself from uncertainty and risk. But the broad duty of the insurer to defend all claims as long as one is potentially covered is essentially gutted if the policyholder must later reimburse the costs of the defense. If the insurer can unilaterally and retroactively revoke its defense obligation, the insurer effectively transfers risk right back to the policyholder, turning the insurer/policyholder relationship on its head. The policyholder then bears the risk of having to fund, retroactively, a defense that was already provided by the insurer. The policyholder is burdened with the very uncertainty it purchased insurance to avoid.

Barring recoupment of defense costs by the insurer is in keeping with the traditional rules of insurance contract interpretation. Insurance policies are near universally, if not universally, deemed contracts of adhesion. The insurer controls the drafting of the policy with little or no input from the policyholder. The policy terms generally are not negotiated and are presented to the policyholder on a “take-it-or-leave-it” basis. Consequently, courts apply contra proferentem to insurance policies, interpreting any ambiguous language or terms in the insurance policy in favor of the policyholder. Similarly, when a policyholder tenders a claim to its insurer for which the insurer is unsure whether the policy language it wrote covers the claim, the insurer should bear the risk of the uncertainty that the court may ultimately rule the claim uncovered.

In addition to the insurer’s superior bargaining position relative to the policyholder, the insurer generally possesses superior expertise in assessing and accounting for risks. When writing the policy, the insurer has the ability to evaluate its exposure to the risk that it will defend claims that are ultimately ruled uncovered and can set premiums accordingly. Moreover, guaranteeing insurers an automatic right of recoupment, particularly when they have not bargained for it, creates disincentives for the insurers to investigate claims and make informed, reasoned judgments about coverage. The insurer would shift the risks attendant to potentially covered claims onto the policyholder: the insurer would no longer face the possibility that claims it defends ultimately could be ruled to be not covered (since the insurer could always seek recoupment from the insured) and the insurer could avoid the potential breach of contract and bad faith claims by defending all claims and then seeking recoupment of the defense costs. Policyholders would never have any assurances that they are receiving a defense from the insurer, rather than just a “loan” to cover defense costs until such time as the insurer pursues recoupment. The insurer can always obtain that transfer-back of risk through an explicit policy provision, but policyholders should not have this risk foisted upon them without agreeing to such a term beforehand.

[c] A Reservation of Rights Creates No Implied Contract or Legitimate Basis for Recoupment

Some insurers argue that although their policies contain no reimbursement provision, they may nonetheless seek reimbursement when they include a statement of their intent to do so in a reservation of rights letter.\textsuperscript{164} This argument should be rejected out of hand because a reservation of rights letter is merely notice from an insurer that it may or will challenge its coverage obligations based on the terms and conditions of its insurance contract. Sending such notice permits an insurer to avoid a later claim that it has waived its policy’s coverage defenses, or

should be estopped from contesting the duties to defend and/or indemnify their insured. As the Washington Supreme Court held in *National Surety Corp. v. Immunex Corp.*, "allowing recoupment to be claimed in a reservation of rights letter would allow the insurer to impose a condition on its defense that was not bargained for."

An insurer can “reserve,” as that term implies, only those rights and defenses that it actually has under the policy. For this reason, a policyholder does not even have to respond to a reservation of rights letter in most states. The better reasoned non-recoupment decisions recognize this, and hold that a unilateral and purported reservation of rights not found in the policy is invalid. It does not create a new contract, amend the insurance policy, or change the parties’ bargained-for rights. Indeed, an insurer’s offer to defend subject to reimbursement attempts to thrust a new contract, unsupported by consideration, on the policyholder, but the policyholder already is entitled under the contract to a defense of potentially covered claims.

Insurers wishing reimbursement should be forthright in dealings with policyholders, consistent with their duties of good faith and fair dealings. To the extent insurers wish to obtain a contractual right to reimbursement, they should draft reimbursement terms (if and as appropriate) for the insurance policies they sell (and not for ROR letters). Alternatively, an insurer can seek a separate bilateral agreement with the insured in which recoupment is negotiated as a term of that separate agreement, supported by new and adequate consideration. But, insurers should not place their policyholders in the impossible position of either accepting the insurer’s additional conditions on its defense or losing the right to a defense to which the policyholder is already entitled.

Courts that permit insurers to obtain reimbursement of uncovered defense costs based on statements made in ROR letters seem to proceed, whether expressly or implicitly, from a mistaken view that the insurer and policyholder are somehow equals in the relationship—financial equals, equals in bargaining power, and equals in their ability to handle risk. As the Sixth Circuit, for example, observed in *United National Insurance Co. v. SST Fitness Corp.*: “When faced with a [ROR], the policyholder can choose to: 1) decline the offer, pay for the defense and seek recovery under the policy; 2) decline the offer and file a declaratory judgment action; or 3) accept the offer subject to the [ROR].” Animated by this view of the insurer-policyholder dynamic, some jurisdictions treat a ROR letter as a new, freely-negotiated contract for the defense of claims. Those courts’ assumption that the policyholder is effectively equal to the insurer also explains their public policy rationales, which tend to be more concerned with protecting insurers than with protecting policyholders from litigation.

Courts rejecting an insurer’s right to reimbursement do not view the insurer and policyholder as effective equals. They correctly observe that a policyholder is not necessarily

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167 1 Jerold Oshinsky & Theodore A. Howard, Practitioner’s Guide to Litigating Insurance Coverage Actions § 2.06 (2d ed. 1998 & Supps. 2009, 2011); *see also* Thomas V. Harris, *Washington Insurance Law* § 17.03, at 17–9 to 17–10 (3d ed. 2010) (recognizing reservation of rights is often accomplished by letter from an insurer and does not require the consent or agreement of the insured).
positioned to reject a defense or consent to a fundamental change in the policy at the point when it has just been sued by a third party and when it is most vulnerable because the risk it transferred has developed into a claim and its insurer is seeking to transfer it back. These courts’ decisions represent the better view of the parties’ relative bargaining power, and that, as discussed, insurance policies are contracts of adhesion whose ambiguities should be construed against the insurer.

These courts also correctly recognize that the insurer, not the policyholder, is the expert in understanding its insurance policy and best positioned to deal with uncertainty because insurers are in the business of pooling, accepting, and further transferring to other insurers, risk. Moreover, these courts effectively acknowledge that if insurers want a “right” to reimbursement, they (not the policyholder) are well-positioned to change their policies to reflect that contractual right. Having opted to instead sell “duty to defend” policies without recoupment/advancement provisions, the insurers should not be able to amend or supplement their written contracts, post-loss, by the unilateral imposition of new terms and conditions through the issuance of reservation of rights letters purporting to relieve the insurer of its obligation to defend potentially covered claims.

[d] Allowing Recoupment by Implied Contract Is Inconsistent with a Policyholder’s Reasonable Expectations

Insurers argue that their policies do not prevent them from resorting to quasi-contractual and equitable theories to obtain reimbursement from a policyholder. As previously detailed, insurance policies are not silent on insurers’ duty to defend potentially covered claims. Given the policies’ clear and express defense obligations, recoupment under quasi-contractual or equitable theories is inconsistent with a policyholder’s reasonable expectations.

The doctrine of reasonable expectations is based on the notion that the objectively reasonable expectations of policyholders regarding the terms of the insurance contracts they purchase will be honored. Policyholders understand and expect their liability policies to protect them against the expense of defending third party suits when those suits allege any claims that are potentially covered. This defense protection is a significant part of what the insured is purchasing when obtaining liability insurance. Given the policyholder’s reasonable expectations based on the contract’s express terms, an insurer should not be allowed to narrow their duty to defend by introducing a right of recoupment, not contained in the policy, and indeed for which it never bargained.

Duty to defend policies are very different from duty to reimburse policies, and policies allowing for advancement of funds. Courts that find a basis for recoupment conflate these  

169 See General Agents Ins. Co. of Am. v. Midwest Sporting Goods Co., 215 Ill. 2d 146, 162 (2005), quoting Shoshone 1st Bank v. Pacific Employers Ins. Co., 2 P.3d 510, 516 (Wyo. 2000) (“The question as to whether there is a duty to defend an insured is a difficult one, but because that is the business of an insurance carrier, it is the insurance carrier’s duty to make that decision. If an insurance carrier believes that no coverage exists, then it should deny its insured a defense at the beginning instead of defending and later attempting to recoup from its insured the costs of defending the underlying action. Where the insurance carrier is uncertain over insurance coverage for the underlying claim, the proper course is for the insurance carrier to tender a defense and seek a declaratory judgment as to coverage under the policy.”). Accord Immunex, 176 Wn. 2d 872, ¶ 30.
different types of provisions and fail to effectuate the policyholder’s reasonable expectations. Liability policies expressly impose an automatic duty on the insurer to defend the insured against claims that may potentially be covered by the policy. This “duty to defend” feature is most often found in primary-layer insurance policies. By contrast, excess liability policies often do not impose automatic duties on the insurer to defend the insured. Instead they offer to pay the insured’s “ultimate net loss,” which includes defense costs the insured incurs defending itself. And, as previously noted, some insurance policies have no duty to defend. The insurer may advance, in certain circumstances, a policyholder’s defense costs.

The contract terms stand in stark contrast to each other:

We will have the right and duty to defend the insured against any Suit seeking those damages.

versus

We shall not be obligated to assume charge of, participate in, or pay for the investigation of any “claim” or “suit.”

versus

The Insurer has the right, but not the obligation, to associate in the defense and settlement of any Claim … . The Insurer is not required to pay Defense Expenses until the Claim is finally settled … . However, if all of the following conditions are satisfied, at the request and on behalf of the Insured, the Insurer shall advance Defense Expenses prior to the final disposition of the Claim.

Allowing reimbursement would result in liability insurance ceasing to function as a protection from litigation. It takes the term from the third quoted policy that an insurer is not required to pay defense costs until final determination of the underlying claim and imposes that onto the primary policy’s obligation to defend. Policyholders would not have the benefit of their insurer-funded defense; they would not have insurer’s appointed counsel’s expertise developing defense strategies. They would instead get an offered advance on defense costs for potentially covered claims, and potentially additional litigation with their insurers over reimbursement rights not actually expressed in the insurance contract.

When an insurer sells an integrated policy obligating it to defend, at its own cost, potentially covered claims, and its policy is entirely silent about any reimbursement for the

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defense provided out of obligation or as of right, the average person purchasing insurance would reasonably expect that the insurer did not intend to provide for itself any reimbursement rights—this is particularly true when an insurer knows how to draft reimbursement provision and advancement provisions, and incorporates them into its other contracts.

[e] The Duty to Defend Expires When It Is Determined a Claim Is Not Covered

When a liability insurer defends its insured under a reservation of rights, the insurer acknowledges and admits a claim is potentially covered and it has a duty to defend. Having so admitted, the insurer is relieved of its duty only when it becomes clear that a claim is not covered. That may be because the facts later develop in a way that reveals the potentially uncovered claim is not in fact covered, the parties agree it is not covered, or the court rules that a policy does not offer coverage.

A contractual undertaking to defend arises when the suit against the insured, construed liberally, is filed alleging facts which could, if proven, impose liability upon the insured within the policy’s coverage. An insurer is not relieved of its duty to defend unless and until the claim alleged in the suit is “clearly not covered by the policy.” Thus, an insurer who is not sufficiently certain of its coverage position, and therefore defends the claim rather than denying it, must bear litigation expenses unless and until a court determines there is no conceivable basis for coverage. Otherwise, the duty to defend would be coextensive with the duty to indemnify, and the insured would lose what may well be the most valuable benefit of its liability insurance policy.

While analyzing coverage provisions and determining how they will be applied as a matter of law may be difficult for insurers (even though they drafted those provisions), it is the insurers’ business. Insurers should carefully weigh whether to defend a claim. If an insurer is uncertain because the facts are not developed or it is not clear how a court will interpret the policy it drafted and sold, the proper course is for it to accept its defense obligations, including the costs associated with it, while it seeks clarification which will guide its future obligations.

That an insurer is responsible to defend a potentially uncovered claim until it is determined that the claim is uncovered may, indeed, better motivate it to draft clear and unambiguous policies.

As one court observed with respect to ambiguities in insurance policies: “courts should consider whether clearer draftsmanship by the insurers ‘would have put the matter beyond reasonable question.’” It also may better motivate insurers to timely investigate claims and make prompt and sound judgments relating to coverage, as is otherwise their obligation.


The law of unjust enrichment is not applicable. The very existence of a contract on the

174 256 P.3d at 445 (internal citations omitted).
subject matter entirely undermines insurers’ theory. The theory also fails because the elements of that doctrine cannot be satisfied where coverage is uncertain and there is accordingly a duty to defend.

Three elements must be established for a party to succeed on a claim based on unjust enrichment. There must be a benefit conferred on one by another; there must be an appreciation or knowledge by the other of that benefit; and there must be acceptance or retention by the other of a benefit under such circumstances as to make it inequitable for the defendant to retain the benefit without payment of its value. Where coverage for a claim is uncertain, there is no undeserved benefit conferred; the insurer, without a policy requiring reimbursement or advancement of funds, simply fulfills its contractual obligation to defend and the policyholder simply gets the benefit of its bargain for which it has already paid value—the premium.

Notably, insurers who argue for unjust enrichment often offer no evidence suggesting that they did not factor into their premium structure instances such as these, where they must provide a defense on a doubtful claim pending court determination whether the duty to defend and indemnify does or does not apply. But, even if they somehow failed to take this type of situation into account in calculating premiums because they misapprehended their duty to defend under the policy they drafted, this would not excuse an insurer’s performance of its contractual obligations or result in some injustice that must be compensated.

The circumstances are entirely foreseeable. Insurers are frequently faced with choosing whether to defend under a reservation of rights and seek relief from the court regarding the obligations to defend and indemnify, with the prospect that they will be responsible for costs incurred in defending their insureds while the duty remains in effect (that is unless their contracts include a reimbursement provision). That the insurers failed to address the circumstances in drafting their policies does not make the defense the policyholders receives under the contract “unjust” or improper.

Even after the policy is issued, the insurer has the option to resist the policyholder’s demand for performance; simply because the insurer accedes to that demand for performance consistent with a contract does not make the policyholder’s demand somehow inappropriate or wrongful.

While the insurer may not welcome making a choice between offering an interim defense or being subject to the consequences if it breaches its contract does not mean that its election is made under compulsion. The insurer’s decision to provide a defense for potentially covered claims is made with eyes wide open. It is not a mistake or a miscalculation by the insurer that confers an unintended benefit upon the insured; it is not an accidental “overpayment” on the insurer’s obligation to the policyholder. Rather, it is a foreseeable consequence of a reasoned decision made by the insurer after weighing the risks based on full knowledge of the available

176 See Excess Underwriters at Lloyd’s v. Frank’s Casing Crew & Rental Tools, Inc., 246 S.W.3d 42 (Tex. 2008); R3RUE §§ 2(1) & 2(2).

177 Massachusetts: Goodwin v. C.N.J., Inc., 436 F.3d 44 (1st Cir. 2006);
facts, policy terms and the law. In essence, it is an insurer acting like an insurer.

Moreover, the insurer benefits by its performance. Recall that liability policies express the defense obligation as both an insurer’s *right* and duty. That is because under a “duty to defend” policy the insurer often has the right to choose defense counsel. In addition, the insurer may have the unfettered right to control a claim’s defense and strategy, including settlement. Furthermore, as the Third Circuit recognized when rejecting an insurer’s unjust enrichment theory, an insurer that offers a defense under a ROR when there is uncertainty as to coverage avoids the risk that a policyholder’s inept or poorly funded defense of the underlying action will cause the insurer greater exposure if it turns out there was a duty to defend and/or indemnify.

In *Westchester Fire Insurance Co. v. Wallerich*, the Eighth Circuit Court of Appeals declined to find that a D&O insurer had a right of recoupment of the defense costs it advanced to the insured, even though the court determined that no duty to defend was owed by the insurer because the “insured versus insured” exclusion applied. The insurer had issued a ROR, which included a reservation of its right to seek recoupment of any defense costs advanced. The *Wallerich* court distinguished and rejected earlier decisions from Minnesota and the Eighth Circuit, concluding that more recent state and federal court decisions’ rejecting recoupment were more persuasive. It explained that the insurer could have included in the policy an express provision for reimbursement, but did not, opting instead to try to unilaterally amend the policy by including the right to reimbursement in its ROR letter. But the involved policyholder had not acquiesced in the insurer’s assertion of this right and, in fact, explicitly rejected the insurer’s alleged reservation of a right to recoupment. Thus, the insurer, having offered an interim defense under these circumstances, and without offering to forgo any right to the insureds in exchange for tendering a defense, had no viable basis to complain or demand reimbursement on an unjust enrichment theory.

[g] Voluntary Payments Are Not Subject to Reimbursement

The thrust of insurer’s reimbursement theories are that they ultimately owe no coverage (as they suspected), but nonetheless provide it and therefore should be reimbursed. To the extent this is the case, the voluntary payment rule defeats insurers’ recoupment demands. The voluntary payment rule is an equitable defense based on the general common law rule that a person cannot recover money which he has voluntarily paid with full knowledge of the facts.  

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180  563 F.3d at 710.
181  563 F.3d at 716–19.
182  563 F.3d at 716–19. While one might argue that a party which inadvertently “overpays” a contract should be permitted to recover under a theory of restitution of unjust enrichment, such logic has no force here. This circumstance cannot be fairly characterized as an “overpayment” on a contract. There is no dispute about whether an insurer paid a certain sum when a lesser sum was due under its contract. There is instead acknowledged uncertainty and ambiguity regarding whether the insurer should pay at all under its contract. Thus, where a contract defines the parties’ obligations in connection with defense of claims, the doctrine of unjust enrichment simply cannot apply.
183  563 F.3d at 716–19.
184  563 F.3d at 716–19.
185  See 70 C.J.S. Payment § 106 (2012).
Application of the voluntary payment rule is not dependent on whether an insurer perceives that it can obtain some timely vindication of what it believes are its contractual obligations and rights. That is because an insurer cannot avoid application of the doctrine based on duress.\textsuperscript{186} The insurer has the ability, and contractual right, to resist a policyholder’s claim when it concludes the claim is not covered. That a policyholder may seek coverage from the insurer, and bring a breach of contract action if coverage is denied, is not duress. The potential for a breach of contract claim cannot be duress, or all contracts would be performed only under duress. Indeed, courts have ruled that the anticipated cost and inconvenience of ordinary legal process in resisting what an insurer contends is an unjustified coverage demand will not permit it to submit to a demand for coverage benefits, and then bring suit in restitution to reclaim the value of its disputed performance.\textsuperscript{187}

Moreover, the insurers are at least as well informed, if not better informed, about contract terms they drafted than their insureds. And, they are no less well informed about the allegations made in the underlying complaints and the available facts. An insurer also may bargain for a contract providing for advancement of defense costs and/or an express right of reimbursement if it intends to have such rights. They can build the risks associated with a “duty to defend” policy into their rate structure (if they have not already done so). In such circumstances, insurers cannot articulate a reasonable claim that they are somehow under duress when a policyholder seeks coverage for a potentially covered claim.

Insurers’ reliance on “circumstantial” duress cases is misplaced. Not only are all the cases cited over 70-years old, insurers’ quintessential example of circumstantial duress—a waiver of premium provision in a disability policy—is entirely inapplicable. Those cases involved policyholders facing circumstantial duress from insurers who disputed the policyholders’ claims and threatened termination of their policies. But as addressed above, the relationship between insurers and policyholders is not one of equals. Insurers are in a superior bargaining position to policyholders, possess superior expertise regarding interpretation and application of insurance policy terms and law, and drafted the insurance policies in the first instance. There is simply no comparison between a policyholder facing circumstantial pressure from the insurer and the potential for breach of contract or bad faith claims against an insurer that fails to defend claims that are ultimately ruled to be covered.

\textbf{[h] The Growing Anti-Recoupment Trend}

Perhaps to buttress their recoupment arguments, insurers tend to argue that the pro-reimbursement cases represent the “majority” view. This is not so. The trend evidenced by decisions such as \textit{Jerry’s Sport, Immunex, Walleric, U.S. Sports Specialty}, and \textit{Welch} suggests


\textsuperscript{187} \textit{See}

\textit{Alabama:} Mount Airy Ins. Co. v. Doe Law Firm, 668 So. 2d 534, 537–39 (Ala. 1995);

\textit{Georgia:} Cotton v. Med-Cor Health Info. Solutions, 221 Ga. App. 609 (1996) (threats of a lawsuit or damage to credit unless a disputed amount is paid do not constitute duress).
the current and prevailing view is that insurers are not entitled to reimbursement. Moreover, the cases, on which the Sixth Circuit relied in *SST Fitness* to predict that Ohio would allow an insurer to recover defense costs, have been questioned and criticized, further undermining insurers’ characterization of decisions allowing recoupment as the “majority” position.

At best for insurers, courts are divided on the issue. Thus, although insurers have experienced some success in establishing a right to recoup in certain circumstances, several well-reasoned opinions suggest that such a right does not exist. Policyholders therefore have ample grounds upon which to reject insurers’ attempts to create rights of recoupment not explicitly provided for in their insurance policies. Policyholders should carefully review their insurance policies and be aware of their own contractual rights before they present a claim to their insurers. Once they tender a claim, policyholders should review and timely respond to an insurer ROR letter that conditions the insurers’ performance on a “right” to reimbursement. As and when appropriate, policyholders should seek counsel to determine the proper course of action.

[6] **Insurer Perspective Reply**

The existence of a contract bars any unjust enrichment claim that would alter the agreed exchange of benefits and burdens. But it does not preclude claims, like those under discussion here, which treat the agreed benefits and burdens as the measure of what is just and permit recovery only to the extent that one party has conferred more benefits than the agreement calls for. Claims for contractual overpayments have consistently been honored by the law of unjust enrichment.

Bank depositors have agreements with their banks. But if the ATM has a glitch and delivers more money than the depositor had in the account, the depositor does not get to keep the excess just because there is no provision in the agreement calling for such repayment. Recovery is due under the law of unjust enrichment, which is a separate branch of the law, distinct from contract and tort. This separation is obscured by the fact that unjust enrichment recoveries are frequently said to be based on a contract implied in law. But all that means is that contractual remedies will be used to effectuate the law of unjust enrichment. The “contract” is a legal fiction.

That brings us back to the key point: what does an insurance policy require to be provided. The duty to defend is determined by comparing the allegations of the complaint with the indemnity coverage of the policy. If the complaint alleges any claim that, if proven, would fall within the indemnity coverage, the insurer must defend. If it does not allege any such claim, there is no duty to defend. If a court ultimately determines that no such claim is alleged, and if the complaint has not been narrowed after it was filed, then there never was a duty to defend. If

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*Georgia:* Grinnell Mutual Reinsurance Co. v. Shierk, 996 F. Supp. 836 (S.D. Ill. 1998);


189 *See SST Fitness*, 309 F.3d at 917–18. The Eighth Circuit rejected *Knapp*, which had allowed the insurer to recover defense costs under Minnesota law and it rejected *Grinnell* and ultimately precluded the insurer from recovering defense costs.

190 This subsection is by Mr. Barker and Ms. Pastor does not endorse any of the views stated.

191 The duty to defend can be prospectively terminated when a plaintiff drops or settles the covered claims or when all such claims have been otherwise disposed of (*See § 3.09 below*). In such a case, there would be
coverage is determined based on the allegations of the complaint, and not on factual developments that narrow those allegations, post-complaint factual developments are simply irrelevant to the existence of a duty to defend. To repeat, the fact that there is a risk that a court might find a duty to defend does not create such a duty if, as the court later finds, there is no duty.

This does not “gut” the duty to defend, but simply confines it to the cases where the terms of the policy actually create a duty. An insured will still get the full benefit of the duty in all cases where a complaint actually does allege (or arguably allege) a claim that, if proven, would fall within the indemnity coverage.

Very few jurisdictions allow supposedly reasonable expectations of policyholders to generate coverage which the terms of the policy deny. Even in those jurisdictions, the authors of this Second Edition of the publication would challenge the reasonableness of any expectation of entitlement to a defense that the policy never promised. Risks that were never transferred by the terms of the policy remain with the insured. A timely reservation of the right to recover defense costs later found not to have been due, should prevent any reliance on any supposed finality of payment.

Of course, an unjust enrichment claim depends on enrichment. But once it is determined that the insurer never had any obligation to indemnify against any of the claims alleged, it becomes clear that the party who actually benefited from the defense was the insured. It matters not that one of the insurer’s motives was self-protection, based on the possibility that some covered claim might have been asserted. The whole basis of the relevant exception to the voluntary payments rule (itself a rule of unjust enrichment law) is the need to protect against the risk that benefits might be due, at a time when adjudication cannot be obtained. The insured, having received benefits that were not due under the contract, must repay them.

American courts and lawyers have not had a good understanding of the law of unjust enrichment, law mostly found in scattered and poorly explained decisions. Courts that have issued anti-recoupment decisions have typically misunderstood that law (or, in some cases, misconstrued the insurance policy). Especially now that R3RUE clearly defines and explains the major features of the law of unjust enrichment, decisions to the contrary ought not to be followed. RLLI does not offer good reasons for imposing an unjust result which allows the insured to retain benefits not due under the contract.


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<td><em>Medical Malpractice Joint Underwr’g Ass’n v. Goldberg</em>, 425 Mass. 46 (1997) (no recoupment of settlement costs permitted because insured did not approve settlement, which insurer made to protect its own interests);</td>
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<tr>
<td>MI</td>
<td>Def</td>
<td>Probabl</td>
<td><em>Budd Co. v. Travelers Indem. Co.</em>, 820 F.2d 787 (6th Cir. 1987) (predicting that recoupment will be allowed); <em>Lumbermen’s Mut. Cas. Co. v. RGIS Inventory Specialists, LLC</em>, 2010 U.S. Dist. LEXIS 50022, at *11–16 (S.D.N.Y. May 20, 2010), aff’d on other issues, 628 F.3d 46 (2nd Cir. 2010);</td>
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<td><em>Stryker Corp. v. XL Ins. Am., Inc.</em>, 2013 U.S. Dist. LEXIS 17230, at *16 (W.D. Mich. Feb. 8, 2013), aff’d mem., 2014 U.S. App. LEXIS 15324 (6th Cir.) (insurer made an unrecoverable voluntary payment when it settled the excess amount of judgment against insured on the basis of a coverage judgment that it was appealing, because failure to settle would expose it to penalty interest if it lost the appeal).</td>
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<td>MN</td>
<td>Def</td>
<td>Probably not</td>
<td>Westchester Fire Ins. Co. v. Wallerich, 563 F.3d 707 (8th Cir. 2009) (predicting that recoupment will not be allowed);</td>
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<tr>
<td>MS</td>
<td>Def</td>
<td>Possibly not</td>
<td>EEOC v. Southern Pub. Co., 894 F.2d 785 (5th Cir. 1990) (in mixed claim case, insurer must bear the entire cost of its insured’s defense when “there is no reasonable means of pro-rating the costs of the defense between the covered and the not-covered items”);</td>
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<td>MO</td>
<td>Def</td>
<td>Probably not</td>
<td>Colony Ins. Co. v. First Specialty Ins. Corp., 2017 U.S. Dist. LEXIS 15882, at *7-9 (S.D. Miss. Feb. 3, 2017) (insurer that defended and settled without any duty to do so was voluntary payor); Miss. Farm Bur. Cas. Ins. Co. v. Amerisure Ins. Co., 2013 U.S. Dist. LEXIS 9592 (S.D. Miss. Jan. 24, 2013) (insurer that was obligated to defend two counts of complaint against its named insured’s insurer alleging vicarious liability but not defend counts alleging direct liability and wanton misconduct, not entitled to recover allocable costs from employer’s insurer, because payment was voluntary).</td>
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<td>MT</td>
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<td>Travelers Cas. &amp; Sur. Co. v. Ribi Immunochem Research, 2005 MT 50 (Mont. 2005);</td>
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<td>Capitol Indem. Corp. v. Blazer, 51 F. Supp. 2d 1080 (D. Nev. 1999) (predicting that recoupment will be allowed);</td>
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<td>Resure, Inc. v. Chemical Distribs., 927 F. Supp. 190 (M.D. La. 1996) (predicting that recoupment will be allowed);</td>
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<td>OH</td>
<td>Def</td>
<td>Probably</td>
<td>United Nat’l Ins. Co. v. SST Fitness Corp., 309 F.3d 914 (6th Cir. 2002) (predicting that recoupment will be allowed); Chiquita Brands Int’l, Inc. v. Nat’l Union Fire Ins. Co., 2015 Ohio App. LEXIS 5299, at ¶ 8 (Dec. 30, 2015) (relying on R3RUE);</td>
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<td>Sett</td>
<td>Yes</td>
<td>Lester v. Sparks, 1978 OK 68 (Okla. 1978);</td>
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<td>OR</td>
<td>Def</td>
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<td>Interstate Fire &amp; Cas. Co. v. Archdiocese of Portland, 899 F. Supp. 498 (D. Or. 1995) (predicting that recoupment will be allowed);</td>
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<td>Am. &amp; Foreign Ins. Co. v. Jerry’s Sport Ctr., Inc., 2 A.3d 526 (Pa. 2010);</td>
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<td>Terra Nova Ins. Co. Ltd. v. 900 Bar, Inc., 887 F.2d 1213, 1219–20 (3d Cir. 1989) (correctly predicting PA law);</td>
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<td>RI</td>
<td>Def</td>
<td>?</td>
<td>St. Paul Fire &amp; Marine Ins. Co. v. Compaq Computer Corp., 457 F.3d 766 (8th Cir. 2006);</td>
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<td>Excess Underwriters at Lloyds v. Frank’s Casing Crew &amp; Rental Tools, Inc., 246 S.W.3d 42, 48–52 (Tex. 2008);</td>
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<td>St. Paul Fire &amp; Marine Ins. Co. v. Compaq Computer Corp., 457 F.3d 766 (8th Cir. 2006);</td>
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<td>Excess Underwriters at Lloyds v. Frank’s Casing Crew &amp; Rental Tools, Inc., 246 S.W.3d 42, 48–52 (Tex. 2008);</td>
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<td>Auto-Owners Ins. Co. v. Prairie Auto Group, Inc., 2008 U.S. Dist. LEXIS 45327, at *9–10 (D.S.D. June 10, 2008) (predicting that recoupment will be allowed);</td>
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<td>Excess Underwriters at Lloyds v. Frank’s Casing Crew &amp; Rental Tools, Inc., 246 S.W.3d 42, 48–52 (Tex. 2008);</td>
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<td>Def</td>
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<td>Cincinnati Ins. Co. v. Grand Pointe, LLC, 501 F. Supp. 2d 1145, 1168 (E.D. Tenn. 2010);</td>
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<td>Excess Underwriters at Lloyds v. Frank’s Casing Crew &amp; Rental Tools, Inc., 246 S.W.3d 42, 48–52 (Tex. 2008);</td>
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<td>UT</td>
<td>Def</td>
<td>Probably not</td>
<td>U.S. Fid. &amp; Guar. Co. v. U.S. Sports Specialty Ass’n, 270 P.3d 464 (Utah 2012); Crist v. Ins. Co. of North America, 529 F. Supp. 601 (D. Utah 1982) (suggesting (in dicta) that the burden of demonstrating any possible apportionment of defense costs rests with the insurer);</td>
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<td>U.S. Fid. &amp; Guar. Co. v. U.S. Sports Specialty Ass’n, 270 P.3d 464 (Utah 2012);</td>
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<td>Nat’l Sur. Corp. v. Immunex Corp., 176 Wn. 2d 872 (2013);</td>
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<td>WI</td>
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<td>Possibly</td>
<td>Krueger Int’l, Inc. v. Fed. Ins. Co., 647 F. Supp. 2d 1024, 1043 (E.D. Wis. 2009) (predicting that recoupment will be allowed);</td>
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<td>WY</td>
<td>Def</td>
<td>No</td>
<td>Shoshone First Bank v. Pacific Empl’rs Ins. Co., 2 P.3d 510 (Wyo. 2000) (decision addresses only mixed claims but seemingly will apply to all);</td>
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Alaska Statute Precludes Recoupment, Even Where Policy Provides for It

In *Attorneys Liab. Prot. Soc’y, Inc. v. Ingaldson Fitzgerald, P.C.*, 192 the Alaska Supreme Court, in answering certified questions, held that an Alaska statute precluded recoupment of defense costs, even where there was no duty to defend and the policy provided for a right of recoupment. Ingaldson Fitzgerald P.C. was sued on claims that were ultimately held not to create any duty to defend. 193 “The policy … contained a provision providing that Ingaldson Fitzgerald would reimburse ALPS for fees and costs ALPS incurred in defending non-covered claims.” 194 ALPS defended under reservation of rights, including a reservation of the right to seek recoupment of the cost of defending noncovered claims. 195 Alaska treats any reservation of rights as a conflict of interest, giving the insured a right to independent counsel. 196 *Alaska Stat. § 21.96.100* addresses the rights of insureds in when such a right arises. The court quotes the key parts of the statute as follows:

**Subpart (a) provides:**

If an insurer has a duty to defend an insured under a policy of insurance and a conflict of interest arises that imposes a duty on the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to the insured unless the insured in writing waives the right to independent counsel.

**Subpart (c) requires:**

If the insurer reserves the insurer’s rights on an issue for which coverage is denied, the insurer shall provide independent counsel to the insured as provided under [subpart] (a) of this section.

**Subpart (d) specifies that if the insured selects independent counsel, the insurer may require that the independent counsel have adequate experience and may limit the independent counsel’s rates to the rate the insurer would pay an attorney in a similar case. It also stipulates:**

In providing independent counsel, the insurer is not responsible for the fees and costs of defending an allegation for which coverage is properly denied and shall be responsible only for the fees and costs to defend those allegations for which the insurer either reserves its position as to coverage or accepts

193 370 P.3d 1101, 1104–05.
194 370 P.3d 1101, 1104.
195 370 P.3d 1101, 1104.
coverage. The independent counsel shall keep detailed records allocating fees and costs accordingly.\textsuperscript{197}

The court construed the statute to preclude any right of recoupment as to noncovered claims that were subject to a duty to defend on account of the inclusion of covered claims in the lawsuit. Turning to the different issue presented by the second certified question, which assumed that the duty to defend never arose and inquired whether a policy provision granting a right to recoupment was unenforceable, the court reasoned as follows:

But what about a circumstance, ALPS asks, in which “the insurer, in an abundance of caution, provides independent defense counsel regardless of whether the insurer has a duty to defend?” This “abundance of caution” hypothetical only underscores the importance of preserving the balance we struck in Continental: An insurer may “affirm the policy and defend unconditionally[,] … repudiate the policy and withdraw from the defense,” or reserve rights and “offer its insured the right to retain independent counsel to conduct his [or her] defense, and agree to pay all the necessary costs of that defense.” To allow insurance companies to disavow the duty to defend but provide independent defense counsel out of “an abundance of caution” gives the insurer an incentive to automatically reserve rights in hopes of obtaining reimbursement for attorney’s fees and to protect itself from claims of bad faith or breach that could result from a repudiation of the policy. Such a result is inconsistent with AS 21.96.100: Under the statute the determinative event giving rise to the insurer’s duty to pay independent counsel is not the often-difficult determination as to the possibility or impossibility of coverage, but the objective act of the insurer taken when reserving its position as to coverage. And it is certainly inconsistent with our previous decisions on this issue. We conclude that Alaska law prohibits reimbursement of fees and costs incurred by the insurer defending claims under a reservation of rights, even in circumstances where it is later discovered that there was “no possibility of coverage” under the policy.\textsuperscript{198}

This reasoning is questionable. By its terms, the statute seems directed to cases where the insurer does have a duty to defend. Moreover, it expressly provides that “the insurer is not responsible for the fees and costs of defending an allegation for which coverage is properly denied and shall be responsible only for the fees and costs to defend those allegations for which the insurer either reserves its position as to coverage or accepts coverage.”\textsuperscript{199} In order to take advantage of that provision, the court’s decision seemingly requires the insurer to refuse to pay

\textsuperscript{197} \textit{ALPS}, 370 P.3d 1101, 1106–07, quoting \textit{ALASKA STAT.} § 21.96.100.
\textsuperscript{198} 370 P.3d 1101, 1111–12.
\textsuperscript{199} \textit{ALASKA STAT.} § 21.96.100(d).
for such expenses, rather than paying and seeking reimbursement. Doing that would risk breaching the duty to defend if the insurer’s coverage position proved incorrect. And insureds would likely wish to at least have the ability to persuade the insurer to advance the costs of such defense by agreeing to reimburse those costs if the insurer’s coverage position proved incorrect.

Be that as it may, the court’s construction of the statute is now the law of Alaska.

However, having received this answer to the certified questions, the Ninth Circuit nonetheless reversed the judgment denying reimbursement.¹ It found that application of the Alaska statute was preempted by the Liability Risk Retention Act of 1986,² 15 U.S.C.S. § 3902(a)(1), because ALPS was a risk retention group chartered in Montana, which permits recoupment.³

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³ 838 F.3d 980-82.
Insured Rights to Independent Counsel

By William T. Barker
Dentons U.S., L.L.P.
233 South Wacker Drive, Suite 7800
Chicago IL 60611
312-876-8140
Fax 312-876-7934
william.barker @dentons.com

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For presentation at
Strafford Publications webinar on "Insurance Defense Costs: Allocation in Mixed Actions, Recoupment for Non-Covered Claims, Independent Counsel Fees" Wednesday, July 26, 2017

William T. Barker is a partner in the Chicago office of Dentons U.S. LLP, with a nationwide practice representing insurers in complex litigation, including matters relating to coverage, claims handling, sales practices, risk classification and selection, agent relationships, and regulatory matters. He sometimes serves as an expert witness on matters of insurance, professional responsibility and standard of care. He is a co-author (with Ronald D. Kent) of INSURANCE BAD FAITH LITIGATION, SECOND EDITION and (with Charles Silver) of PROFESSIONAL RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL. He has been described as the leading lawyer-commentator on the connections between procedure and insurance. See Charles Silver & Kent Syverud, The Professional Responsibilities of Insurance Defense Lawyers, 45 DUKE L.J. 255, 257 n.4 (1995).

Mr. Barker is a member of the American Law Institute and an Adviser to its project on the Restatement of the Law of Liability Insurance. He is a Special Advisor to the ABA Standing Committee on Ethics & Professional Responsibility. He is a past Director of the Association of Professional Responsibility Lawyers. He is Co-Chair of the Subcommittee on Ethics of the ABA Section of the Litigation Insurance Coverage Litigation Committee and a Vice Chair of the ABA Tort Trial & Insurance Practice Section ("TIPS") Committee on Insurance Coverage Litigation. He is TIPS Liaison to the ABA Standing Committee on Lawyers’ Professional Liability, a past Chair of the TIPS General Committee Board, the TIPS Ethics & Professionalism Committee, the TIPS Appellate Advocacy Committee, and the TIPS Robert B. McKay Law Professor Award Committee.
Chapter 6 Policyholder’s Rights to Independent Counsel

SYNOPSIS

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§ 6.02 Relationship of Insurance Law to Rules of Professional Responsibility
§ 6.03 Relationship of Reservation of Rights to Right to Independent Counsel
§ 6.04 A Disabling Conflict Exists When Carrier and Policyholder Have Divergent Interests in the Way the Case Is Defended

[1] Coverage Related Conflicts
[a] General Principles
[b] Examples
[i] Coverage Issues That Don’t Create Conflicts
[ii] Conflict-Creating Coverage Issues

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[b] Basic Conflict Standard
[c] Relationship of the Coverage Issues to Those in the Underlying Action
[d] Risks Posed By the Coverage Issues to the Representation in the Underlying Action
[e] Implications

[3] Cross-Insureds

[4] Multiple Policyholders with Inconsistent Defenses


[7] Davalos: Possible Conflicts Regarding a Policyholder’s Affirmative Claim

[8] Questionable Cases on Contested Course and Scope of Employment

[9] Excess Exposure Generally Does Not Create a Conflict
[10] But the Seventh Circuit Has Held That a Sufficient Risk of an Excess Judgment Sometimes May Create a Conflict
[b] The Seventh Circuit’s Opinion
[c] Supplemental Opinion
[d] Responses to Wegman
[i] Narrow Construction

[ii] Wegman Incorrectly Interprets Illinois Law, Especially if Not Narrowly Construed
[A] In Illinois, the Right to Independent Counsel Is Determined by the Rules of Professional Conduct
[I] Maryland Casualty Co. v. Peppers
[II] Application of the Peppers Standard
[B] Wegman Did Not Apply the Peppers Standard
[11] Punitive Damages Claims May Create a Conflict
[12] Possible Recoupment Claims and Burning Limits Policies
[a] Recoupment
[b] Burning Limits Policies

[14] Disagreements Between Carrier and Policyholder Regarding Conduct of the Defense
[15] Conflicts of Interest Resulting from Other Representations Involving the Same Policyholder
[a] Conflicts May Arise from Current or Former Representations
[b] Current Representation Conflicts
[c] Former Representation Conflicts
[16] Differing Interests of Client Constituents
[17] Differing Preferences on Settlement
[18] Litigation Over Liability Arising From Post-Claim Conduct

§ 6.05 Minority Rule: Right to Independent Counsel Whenever Coverage Disputed

[1] Reject the Defense Rule
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[b] Potential for Reform
The “Enhanced Duty of Good Faith”

Tank v. State Farm Fire & Casualty Insurance Co.
Finley v. Home Insurance Co.

Comment

What Rule Does New York Follow?

Second Circuit Conclusion

The New York Rule: Independent Counsel Is Required Only Where Coverage and Liability Issues Are Intertwined or There Is Some Other Rule 1.7 Conflict

§ 6.06 New Jersey Holds that a Conflict Converts the Duty To Defend to a Duty To Reimburse

§ 6.07 Waiver

§ 6.08 Assigned Counsel Duties When Policyholder May Have Rights to Independent Counsel

[1] Confirming the Retention To Represent the Policyholder

[2] Advising a Policyholder Regarding Possible Rights to Independent Counsel

§ 6.09 Choice of Law on Right to Independent Counsel

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§ 6.04 A Disabling Conflict Exists When Carrier and Policyholder Have Divergent Interests in the Way the Case Is Defended

[1] Coverage Related Conflicts

[a] General Principles

The governing standard is stated in ABA Model Rule 1.7, which is substantively identical on this point to the law in all states:

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:

1. the representation of one client will be directly adverse to another client; or

2. there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.

A material limitation (as that term is used in paragraph (a)(2) of the rule) exists when “there is a significant risk that a lawyer’s ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer’s other responsibilities or interests.” In applying this standard to insurance representations, courts have demanded special sensitivity to any situation where the choices made by defense counsel could benefit the carrier at the policyholder’s expense.

MODEL RULES OF PROF’L CONDUCT R.1.7, cmt. [8].
Where the existence of divergent interests in the conduct of the defense is inherent in the case, the conflict of interest rules require that representation on behalf of the carrier be declined, unless all affected clients give informed consent.  

Note that a primary determinant of whether there is a conflict is the question of whether the lawyer’s duties to carrier and policyholder conflict. Those duties depend, in part, on the scope of the representation. Thus, if defense counsel were also providing coverage advice to the carrier regarding the suit, there would always be a conflict with the interests of the policyholder. But, by limiting the scope of the representation to defense of the suit against the policyholder, conflicts relating to possible coverage advice are avoided. With that limitation of the scope of the representation in place, there is no conflict unless there is a substantial risk that something defense counsel might do when defending the policyholder would advance the interests of one party while harming the interests of the other.

A leading legal malpractice treatise agrees:

Objectively, a conflict exists when the issue upon which the clients’ interests diverge is within the scope of the attorney’s retention. The dilemma is that competent representation of one client on the issue necessarily will be adverse to the interests of the other client. A coverage issue rarely presents an objective conflict of interests if counsel’s retention is limited to defending the liability claim.  

The scope of representation determines the objectives of the representation and the range of services defense counsel is obliged to provide. The scope thus determines the set of actions (or possible actions) defense counsel must be able to provide without conflict. However, the scope of the representation does not limit the range of interests which defense counsel must avoid injuring. A lawyer must respect all interests a client has, including primary interests that relate to the agreed goal of a representation and secondary interests that do not. A policyholder’s interest in preserving coverage and a carrier’s interest in defeating it are secondary interests. They are not the interests defense lawyers signed on to advance. But they are interests nonetheless. Consequently, when acting within the scope of a defensive representation, defense lawyers must respect them. When defending liability suits, they must not knowingly act in ways that endanger clients’ coverage-related interests without informing clients and obtaining consents.

Scope of representation and uncertainty as to the nature of the claims that would be asserted are significant factors justifying the refusal in Quality Concrete Corp. v. Travelers Property Casualty Co. of America to require the carrier to pay for the policyholder’s independent representation.

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2 See


3 Ronald E. Mallen & Jeffrey M. Smith, LEGAL MALPRACTICE, § 30:21, at 334 (2012 ed.).
A young boy had died while trespassing on Quality Concrete’s property. A lawyer representing the estate contacted both Quality Concrete and Travelers. Travelers told Quality Concrete of the contact with it and also told Quality Concrete that Travelers had hired a law firm to represent Quality Concrete regarding the matter. Almost ten years before, there had been a similar death, and Travelers stated that its defense was under a reservation of rights: “[i]f punitive damages are sought due to any allegations of gross negligence, recklessness, and/or willful and wanton conduct (based upon prior incidents on the property)[,] [p]unitive damages, if pled and awarded, would not be covered under the insurance contract.”

The letter also noted that Quality Concrete might want to consult its personal counsel, at its own expense, regarding the matter. Quality Concrete did retain its own counsel, which it claimed was necessary because of the reservation. Travelers settled the matter without any suit being filed. Quality Concrete sought reimbursement for the cost of its counsel, which Travelers refused.

In the absence of a complaint against Quality Concrete, the Rhode Island Supreme Court summarily determined that there was, as yet, no conflict. The result seems correct for several reasons. First, the court reports no indication that a punitive damage claim would actually be asserted. Second, many punitive damage claims do not create conflicts, and it is not clear that this one did. (See § 6.04[11] below.) Third, it appears that defense counsel’s services were limited to trying to settle the case within the policy’s coverage, something on which there was no conflict. Thus, a narrow scope of representation avoided any conflict. To be sure, Travelers could have conducted such negotiations through counsel representing only itself, but Quality Concrete was not harmed by joint representation.

[b] Examples

[i] Coverage Issues That Don’t Create Conflicts

Whether a coverage dispute creates an interest conflict depends on the nature of the coverage issue. In other words, the mere existence of a question as to coverage (and a
corresponding reservation of rights) may not entail a conflict.⁹

Some courts rest this conclusion, in part, on the assumed integrity of counsel:

“Public policy requires the insurer to act with the utmost good faith. As long as this standard is observed, the Court may not interfere with the terms of the parties’ agreement. To hold that the insurer who, under reservation of rights, participates in selection of counsel, automatically breaches its duty of good faith is to indulge the conclusive presumption that counsel is unable to fully represent its client, the insured, without consciously or unconsciously compromising the insured’s interests. The Court is unable to conclude that [the] law professes so little confidence in the integrity of the bar of this state.”¹⁰

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⁹ E.g.:

**US/LA**—Trinity Universal Ins. Co. v. Stevens Forestry Serv., 335 F.3d 353, 356 (5th Cir. 2003);


**NV**—State Farm Mut. Auto. Ins. Co. v. Hansen, 357 P.3d 338, 343 (Nev. 2015) (rule derives from Rules of Professional Conduct; “dual representation is appropriate so long as there is no actual conflict”; “joint representation is permissible as long as any conflict remains speculative”);


**IN**—Siebert Oxidermo, Inc. v. Shields, 430 N.E.2d 401, 403 (1982) (“We consider the argument [that carrier-appointed counsel had a conflict in moving to vacate a default judgment resulting from policyholder’s late notice] impertinent, if not scandalous. Without considering the respected reputation of the attorney involved, we point out that on a daily basis defense attorneys employed by insurance carriers on behalf of policyholders are called upon to deal with matters in litigation where the interests of the policyholder and the carrier do not fully coincide. Under such circumstances the attorney’s duty is, of course, to the insured whom he has been employed to represent. In response the defense bar has exhibited no inability to fully comply with both the letter and spirit of Canon 5 of the Code of Professional Responsibility. If it were otherwise we suspect the desirability of requiring carriers to supply defense counsel would have long since disappeared as a term of the policy.”; also, any arguable deficiencies in presentation by carrier-appointed counsel had been cured by personal counsel’s motions for reconsideration).

**AZ**—An unreported Arizona decision apparently took this view, concluding that the policyholder’s interests are sufficiently protected by the fact that a conflict precludes dual representation, so that counsel is obliged to act solely in the policyholder’s interest. Mirage Homes Constr., Inc. v. Auto-Owners Ins. Co., 1 CA-CV 05-0114 (Ariz. Ct. App. Feb. 9, 2006), relying on Paradigm Ins. Co. v. Langerman Law Offices,
While the integrity of counsel is one protection for the policyholder, there is no need to rely on that unless counsel would have some opportunity to benefit the carrier, at the policyholder’s expense, by the way counsel handles the defense. It is the existence of such an opportunity that creates a conflict of interest entitling the policyholder to independent counsel. (See §§ 6.04[1][a], 6.04[2] below.) In the absence of such an opportunity, there is no conflict and no need to rely on counsel to resist a nonexistent temptation to favor the carrier.

Courts less trusting in the integrity of defense counsel often miss the central question, which is whether a particular case involves any concrete prospect that defense counsel would have an opportunity to favor the carrier at the expense of the policyholder. Only if the manner of handling the policyholder’s defense could affect the determination of coverage or otherwise benefit the carrier at the policyholder’s expense does a conflict exist, and many coverage questions are unrelated to the matters at issue in the tort action. Ordinarily, actions reasonably calculated to minimize the expected loss in the liability action could only make both carrier and policyholder better off, regardless of any collateral dispute they may have regarding coverage. The reason for this is that the coverage dispute will determine whether the carrier or the policyholder bears the loss, and the loser, whoever it turns out to be, will be better off if the loss is smaller rather than larger.

#Comment Begins
Example 1:
Assigned counsel is asked to defend a case involving an auto accident in which the policyholder’s cousin was injured when the car operated by the policyholder ran into a tree. The cousin had been living with the policyholder while attending a nearby school for a semester, but has returned to his parents’ home after being released from the hospital. The claim representative assumes the policyholder’s defense, but reserves the right to deny coverage under the policy’s exclusion for injuries to relatives residing in the policyholder’s household. Coverage counsel brings a declaratory judgment action to resolve that issue. Because the resident relative issue does not overlap with the issues in the tort action, it does not create any conflict of interest, and assigned counsel may undertake the defense.

#Comment Ends

#Comment Begins
Example 2:

P.A., 200 Ariz. 146, ¶¶ 16, 18 (Sup. Ct. 2001). Paradigm Insurance addresses the duties of defense counsel selected by the carrier but does not consider whether or when a policyholder might have the right to independent counsel. Where a carrier is obliged to defend two insureds, one of whom claims over against the other, an Arizona court has held that the policyholder subjected to the cross-claim is entitled to independent counsel at the carrier’s expense. Joseph v. Markovitz, 27 Ariz. App. 122 (1976).

AK—CHI of Alaska, Inc. v. Emp’trs Reins. Corp., 844 P.2d 1113, 1116–17 (Alaska 1993) (“Where there is a conflict between insurer and insured, appointed counsel may tend to favor the interests of the insurer primarily because of the prospect of future employment.”).


Policyholder is a roofing subcontractor. After completion of a building, owner sues the general contractor and the subcontractor, claiming that defects in the workmanship of the roof have caused the roof to deteriorate, resulting in leaks that damaged the floor below the roof and the contents of the building. Claim representative assumes the defense, but reserves the right, under the work/product exclusions, to deny coverage for repair or replacement of the roof itself. Assigned counsel may undertake the defense, because the handling of the defense cannot shift liability between covered and non-covered grounds. The cost of repairing the roof will be a readily determinable amount and tort liability for both covered and non-covered damages will be a single issue.

#Comment Ends

It is sometimes argued that the carrier may not have the incentive to fund a full and vigorous defense of a claim that, if established, will not be covered (even though a finding for plaintiff on that claim would not benefit the carrier either). But if a carrier defends at all, it is obliged to provide a proper defense for the claim, whether or not it would have any obligation to indemnify against that claim. By analogy to the law governing a carrier’s duty to settle, this should be a defense as vigorous as that would be provided by a carrier liable for the entire claim.

The carrier can be liable for any damage resulting from failure to provide an adequate defense. Both the propriety of any alleged skimping on the defense and the causal relation of any impropriety to any resulting non-covered liability are likely to be decided, after a bad result and in hindsight, by a jury unlikely to be sympathetic to the carrier.

So long as there is no opportunity for defense counsel to shift liability between covered and noncovered grounds by defending the case one way rather than another, the better reasoned cases do not regard mere lack of a duty to indemnify against some or all claims asserted in the suit as creating a conflict.

14 See


15 E.g.,


16 See WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 2.03[[2][d]].

17 William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 3.07.

18 IL—Pekin Ins. Co. v. Home Ins. Co., 134 Ill. App. 3d 31, 35 (1985) (policy exhausted, but duty to defend not terminated; no right to independent counsel);

US/TX—Coats, Rose, Yale, Ryman & Lee, P.C., 830 F. Supp. 2d 216, 220–22 (N.D. Tex. 2011) (claims for malpractice (covered) and fee forfeiture (not covered) did not create conflict because no plausible way they could be defended that would shift covered damages to noncovered).
This point was emphasized and illustrated in *Federal Insurance Co. v. MBL, Inc.* 18.1 MBL was sued for soil and groundwater contamination. Its insurers agreed to defend under various reservations of rights but (with one exception) refused to fund independent counsel, contending that there was no conflict of interest requiring independent counsel. The superior court granted the insurers a declaration that they were not obligated to provide independent counsel, and the court of appeal affirmed. It reasoned that not every reservation of rights entitles the insured to independent counsel:

“There is no such entitlement, for example, where the coverage issue is independent of, or extrinsic to, the issues in the underlying action or where the damages are only partially covered by the policy.” However, independent counsel is required where there is a reservation of rights “*and* the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim.” 18.2

But it recognized that the conflict issue arises before counsel acts disloyally:

The duty to appoint independent counsel is not triggered at the moment defense counsel makes a tactical decision giving rise to a conflict. Instead, the parties’ respective interests must be analyzed to determine if they can be reconciled or if there is a conflict of interest which puts appointed counsel in the position of having to choose which master to serve. 18.3

MBL argued that conflicts existed because certain policies contained qualified pollution exclusions (i.e., ones with an exception for sudden and accidental pollution). But those insurers had not reserved their rights with respect to those exclusions, and “[w]here the insurer has not expressly reserved its right to deny coverage under a particular exclusion in its policy, there can be no actual conflict based on the application of that exclusion during the pendency of the action.” 18.4 The fact that the reservation of rights letters included general reservations of rights did not alter that conclusion. 18.5

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18.2


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**CA**—219 Cal. App. 4th at 42.

18.4

**CA**—219 Cal. App. 4th at 44.

18.5

**CA**—219 Cal. App. 4th at 44.
An insurer’s reservation of rights based on its absolute pollution exclusion, which included an exclusion for government demands to monitor and clean up such pollution, did not create a conflict “since [defense] counsel could not control the outcome of that inquiry.”  

Similarly, reservation of the right to deny coverage for damages occurring outside the policy period, because “[d]efense counsel could not control the facts at issue.”

The fact that the insurers were defending other alleged polluters did not create any conflict where there were no adversarial activities among those insureds.

In theory, a conflict could also arise if, when handling the defense, defense counsel would gain access to confidential information which defense counsel would be obliged to disclose to the carrier and which the carrier would find useful in asserting its coverage defenses. But defense counsel would not be obliged to disclose (and would actually be prohibited from disclosing) confidential information that was not relevant to the actual defense of the case. (See § 10.03, below.) Consequently, as long as the defense issues and the coverage issues do not overlap, that theoretical possibility ordinarily should not matter. A merely theoretical possibility is not enough to create a conflict, absent some concrete prospect that adverse disclosure might occur in the matter at hand.

Additionally, it is sometimes suggested that “if there are several theories of recovery, at least one of which is not covered under the policy, the carrier might conduct the defense in such a manner as to make the likelihood of a plaintiff’s verdict greater under the uninsured theory.”

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18.6

CA—219 Cal. App. 4th at 44.

18.7

CA—219 Cal. App. 4th at 47.

18.8

CA—219 Cal. App. 4th at 45–46. See also

US/TX—Graper v. Mid-Continent Cas. Co., 756 F.3d 388, 393–94 (5th Cir. 2014) (reservation based on policy period did not create conflict with respect to policyholder’s statute of limitations defense, because date of occurrence for coverage purposes depended on the date of actual injury, while limitations depended on date injury was discovered).

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AK—CHI of Alaska, Inc., 844 P.2d at 1116.

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RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS, § 121, cmt. c(iii) (“There is no conflict of interest … unless there is a ‘substantial risk’ that a material adverse effect will occur …. In this context, ‘substantial risk’ means that in the circumstances the risk is significant and plausible, even if it is not certain or even probable that it will occur. The standard requires more than a mere possibility of adverse effect.”).

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AK—CHI of Alaska, Inc., 844 P.2d at 1116.
the different theories of recovery are alternate claims for the same injury (e.g., intentional v. negligent), that would involve a conflict, because the carrier might then recommend a defense calculated to increase the likelihood that a verdict adverse to the policyholder would be based on the uncovered theory (here, intent). But suppose the policy were an auto insurance policy and the complaint alleged both bodily injury and defamation in connection with an auto accident. Ordinarily, there would be no plausible way to reduce the covered bodily injury liability by inflating the uncovered defamation claim. So a reservation of the right to deny coverage for the latter would not create a conflict of interest.

It has been suggested that counsel appointed by a carrier failed to properly represent a policyholder by not developing evidence favorable to coverage. But, if the evidence in question is irrelevant to the policyholder’s liability, as it appears to have been in that case, defense counsel has no reason to develop it and, indeed, it is outside the scope of a defense representation. (See § 8.04[6] below.) If such evidence is to be developed, that should be done by coverage counsel, paid by the policyholder, not by defense counsel (independent or otherwise).

In sum, a reservation of rights can create a conflict of interest, but does not always do so. The particular facts of a given case must be examined to determine whether a conflict exists.

[ii] Conflict-Creating Coverage Issues

The defense may affect a coverage determination if the same facts are implicated both in fixing liability and in determining coverage (such a fact being known as a “pivotal fact”). To be sure, the policyholder could not be estopped by an adverse determination if the litigation were controlled by a carrier with an adverse interest on that issue. But counsel would need to develop the evidence bearing on that issue, including the knowledge of the policyholder, would need to communicate with both carrier and policyholder about defense of the issue and evaluation of the prospects on it, and would need to present the evidence and argue it to the factfinder. Witness testimony may be shaped to some degree by the way the witness is prepared and questioned, and the shaping of the first presentation may affect the later testimony of the witness. Findings in the underlying case may affect the coverage case, even if they do not control that case. And a joint representation might give the carrier access to information from the policyholder that would

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22 See, e.g.,

TX—Boyles v. Kerr, 855 S.W.2d 593, 603–04 (Tex. 1993) (concurring op.). Plaintiff sued for intentional invasion of privacy, intentional infliction of emotional distress, and negligent infliction of emotional distress, based on defendant’s conduct in covertly videotaping her having sexual intercourse with him and then showing the tape to his friends. At the close of trial, plaintiff moved to drop the claims of intentional wrongs and defense counsel moved to dismiss the claim of negligent infliction of emotional distress on the ground that no such claim was recognized. Plaintiff’s motions were granted and a verdict for plaintiff returned, but the Texas Supreme Court agreed that there was no general claim for negligent infliction of emotional distress. Had the defense motion been granted and the case gone to verdict on the claims of intentional injury, that would have been injurious to defendant’s interests. The case does not indicate whether defense counsel was independent or whether the defendant gave informed consent to the defense strategy adopted.


24 RESTATEMENT (SECOND) OF JUDGMENTS, § 58(2).
otherwise be confidential.

So, if the case involves a “pivotal fact,” then there typically will be an irreconcilable conflict. Counsel must advocate a position and attempt to shape the evidence regarding the pivotal fact and any position will be contrary to the interests of one client or the other. By shaping the defense, counsel could thus shift liabilities found by the court between covered and non-covered status. Where the coverage issues present such an opportunity, the policyholder is entitled to independent counsel unless the policyholder gives informed consent to the conflict.

For example, if the policyholder is sued on alternative theories of negligence and battery, the former will typically be covered but the latter will not. Of course, the carrier and the policyholder share an interest in defeating the suit entirely and in minimizing any judgment. But if liability is found, the policyholder would prefer that it be based on (covered) negligence, while the carrier’s interest would be served if it were based on (noncovered) battery. In such a case, the policyholder’s intent is a pivotal fact. Because the way in which the case is defended has a real possibility of affecting the basis on which any liability would be found, this divergence of interest creates a conflict of interest for any defense counsel seeking to advance the carrier’s interest as well as that of the policyholder.  

In addition to the alternative allegations of negligent and intentional conduct already noted, such conflict-creating issues have been found in a number of other situations. Examples include:

• whether or not the policyholder complied with applicable safety regulations relied upon in defining coverage;  

• whether products liability results from a design defect or a manufacturing error;

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25E.g.:


IL—Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187, 198–99 (1976) (same);  

MD—Brohawn v. Transamerica Ins. Co., 276 Md. 396, 414–15 (1975) (same);  


26See, e.g.:  


27See, e.g.,  

US/UT—United States Fid. & Guar. Co. v. Louis A. Roser Co., Inc., 585 F.2d 932 (8th Cir. 1978) (Utah
• whether liability of an attorney trustee was based upon erroneous legal judgment or bad business judgment;\textsuperscript{28}

• whether the injured claimant was an employee or an independent contractor;

• whether or not the subject property was damaged while in the policyholder’s possession, custody, and control;\textsuperscript{29} and

• whether property damage was caused by the work of the insured (not insured) or by the work of a subcontractor (insured).\textsuperscript{29.1}

Another example of a case where a conflict may be predicated on the carrier’s potential ability to manipulate the defense for its own benefit is one where the complaint alleges multiple acts of malpractice, one of which was during the carrier’s policy period and the others of which occurred while the defendant hospital was self-insured.\textsuperscript{30} Thus, control of the defense might allow the carrier to shape the case so that any liability found for injuries relating to a single course of treatment would be based on acts subsequent to (rather than those prior to) expiration of its policy, thus potentially converting a covered loss into a non-covered one.

Because a plaintiff’s pleadings do not bind a carrier, a reservation of rights can issue even when a complaint asserts only covered allegations. This may happen, for example, when a plaintiff sues not only for negligence but the alleged misconduct by the policyholder that may have been intentional. Recognizing that the plaintiff may obtain a judgment based on negligence, the carrier may want to preserve its ability to contend that the injury was really intentional in later coverage litigation, and may issue a reservation of rights letter for this reason.

In crafting a negligence defense in this situation, counsel would necessarily be exposed to confidential information about the policyholder’s conduct, information that might be relevant to


\textsuperscript{29}E.g.: US/AZ—Manzanita Park, Inc. v. Ins. Co. of N. Am., 857 F.2d 549, 552–53, 555 (9th Cir. 1988);


MN—Prahm v. Rupp Constr. Co., 277 N.W.2d 389, 391 (Minn. 1979);


settlement evaluation or, possibly, even to defense against the negligence allegation. Accordingly, defense counsel could not engage in the free exchange of all defense-related information which is the norm for assigned counsel. (See § 10.02, below.) That means that independent counsel can sometimes be required even where the complaint makes no allegation of non-covered liability.


[a] The Case

In Armstrong Cleaners, Inc. v. Erie Insurance Exchange,\(^3\) the Indiana Department of Environmental Management determined that a dry cleaning operation was a potential source of cleaning solvents in groundwater. The facility was owned by Mary Ivey, who had leased it to Richard and Betty Armstrong and their corporation from 1989 to 1996 and had leased it to Ronald and Carolyn Ray both before and after the lease to the Armstrongs. Erie Insurance Company had insured the Armstrongs during their tenure as lessees.\(^3\)

The Department notified Ivey and the Rays that they were potentially responsible parties (“PRPs”) for cleaning up the pollution. Ivey sued her carrier, State Farm for coverage, and State Farm sued the Rays, the Armstrongs, and their carriers. Erie assumed the defense of the Armstrongs, while reserving its right to deny coverage if it were determined (1) that the contamination was not an “occurrence” (that is, an “accident”) or (2) if the Armstrongs expected or intended the contamination. Erie also reserved its rights under the pollution exclusion in its insurance policy.\(^3\) When Erie refused to pay the Armstrongs’ independent counsel, they brought this action to establish their right to independent counsel and recover fees they had incurred for such counsel.

[b] Basic Conflict Standard

In addressing this issue, the court recognized that whether the policyholder is entitled to independent counsel “is governed at its core by the Rules of Professional Conduct that address conflicts of interest where an attorney has multiple clients or where a third party is paying the attorney to represent a client (such as the insured).”\(^3\) “In cases where the handling of the underlying litigation may affect whether the claim is covered or not covered, the conflict of interests may be sufficiently clear and immediate that one attorney cannot represent the interests


\(^{32}\) 364 F. Supp. 2d at 802–03.


\(^{34}\) Armstrong Cleaners, 364 F. Supp. 2d at 807 (applying Indiana Rules of Professional conduct).
of both the carrier and the insured.”35

But applying this standard requires case-by-case, fact-specific analysis:

Under this standard, parties and courts cannot resort to easy rules of thumb. “There is no talismanic rule that allows a facile determination of whether a disqualifying conflict exists. Instead, ‘[t]he potential for conflict requires a careful analysis of the parties’ respective interests to determine whether they can be reconciled … or whether an actual conflict of interest precludes insurer-appointed defense counsel from presenting a quality defense for the insured.’ ”

“Whether the potential conflict of interest is sufficient to require the insured’s consent is a question of degree that requires some predictions about the course of the representation. If there is a reasonable possibility that the manner in which the policyholder is defended could affect the outcome of the insurer’s coverage dispute, then the conflict may be sufficient to require the insurer to pay for counsel of the policyholder’s choice. Evaluating that risk requires close attention to the details of the underlying litigation. The court must then make a reasonable judgment about whether there is a significant risk that the attorney selected by the insurance company will have the representation of the policyholders significantly impaired by the attorney’s relationship with the insurer.”36

[c] Relationship of the Coverage Issues to Those in the Underlying Action

Under the standard thus articulated, the court agreed that the reservation under the pollution exclusion did not create any conflict, nor did a generic reservation of the right to deny coverage if some new facts implicated a coverage defense.37 The prospect of unknown facts turning up did not pose a “significant risk” to the representation and the pollution exclusion was both unenforceable and unrelated to the issues presented in the defense of the case.38

The “occurrence” requirement and the “expected/intended” exclusion raised essentially

36 US/IN—364 F. Supp. 2d at. 808 (emphasis added, citations omitted).
the same questions for purposes of conflict analysis. Liability issues in the underlying action did not pose any conflict, because they turned only on whether the Armstrons “caused or contributed to” the release of a hazardous substance. Culpability, even to the extent of negligence, was not an issue in the underlying action, so there would have been no overlap with the coverage issues.39

But the court’s analysis did not stop with the liability issues. When it came to allocation of liability among those contributing to the contamination, issues of culpability and degree of care would be at issue. Thus, State Farm and the Rays, would have “powerful incentives” to show culpability by the Armstrons in order to maximize the Armstrons’ share of the total liability.40 The law on allocation “invite[s] evidence” as to “the Armstrons’ knowledge, intent and degree of care.”41 Moreover, findings of fact and explanations of decisions about allocation might well address issues of knowledge and intent.42 Thus, while there was no overlap between coverage and liability issues on the main claim, there was such an overlap on the cross-claim.

[d] Risks Posed By the Coverage Issues to the Representation in the Underlying Action

“The question under Rule of Professional Conduct 1.7(a)(2) is whether there is a ‘significant risk’ that an attorney selected by the insurer and subject to its direction would be ‘materially limited’ in representing the Armstrons by a relationship with the insurer … .”43 If the Armstrons were found to be contributors to the contamination, Erie’s interests might be served by a “less than vigorous defense” on the allocation issues if findings of culpability might aid its coverage defense.44 Moreover, defense counsel would need to investigate facts and conduct discovery on the remedial issues and would need to advise Erie on the results of that investigation and discovery so that Erie could take it into account in making decisions about settlement or defense strategy.45

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“Such information could easily work to the detriment of the Armstrongs in the coverage dispute with Erie.”\textsuperscript{46} Moreover:

Erie apparently felt it had sufficient information about the situation at the Tillotson location to reserve its rights based on the ‘expected or intended’ exclusion and the definition of an occurrence. The prominence of those same factual and legal issues in the remedial portion of the underlying litigation, together with the specific terms of Erie’s reservation of rights, means that the undisputed facts show a significant risk that attorneys selected by the insurer would be materially limited in their representation of the Armstrongs.\textsuperscript{47}

The court emphasized that it was not “adopt[ing] … a per se rule.”\textsuperscript{48} Rule 1.7(a)(2) “requires a close look at the nature of the conflicting interests, the issues in the underlying litigation, and the risk that the attorney’s relationship with the insurer will materially limit his representation of the insured.”\textsuperscript{49}

While Erie had divided the claim file, with different adjusters for defense and coverage, that did not obviate the conflict. To the extent that the concern was disclosure or use of the policyholder’s confidential information, supervisors with responsibility for both files could make use of such information. Moreover, the defense adjuster knew the terms of the reservation of rights and would therefore be able to identify aspects of the case where Erie’s coverage interests would be implicated by defense decisions the adjuster would make.\textsuperscript{50}

[e] Implications

*Armstrong Cleaners* calls attention to the need to consider aspects of the likely litigation beyond simply the elements of the plaintiff’s claim. Conflicts may arise from litigation with co-defendants, so the issues that might arise with the co-defendants must be considered in deciding whether there is a conflict requiring independent counsel. If a reservation has been asserted, defense counsel should assume that there is a significant risk that some evidence might support that reservation. If that would create a conflict, it may be necessary for the policyholder to have

\textsuperscript{46} US/IN—364 F. Supp. 2d at 815–16.

\textsuperscript{47} US/IN—364 F. Supp. 2d at 816.

\textsuperscript{48} US/IN—364 F. Supp. 2d at 816.

\textsuperscript{49} US/IN—364 F. Supp. 2d at 816.

\textsuperscript{50} US/IN—364 F. Supp. 2d at 817.
independent counsel, unless the carrier will withdraw the reservation.

Another case involving similar analysis is *Schaefer v. Elder.* Elder was a general contractor, insured by CastlePoint National Insurance Co. Elder contracted to design and build a residence for Schaeffer, who sued him. CastlePoint provided a defense subject to a reservation of rights based on a policy provision denying coverage for work done by independent contractors unless prior to the date of any occurrence giving rise to the suit, the insured had received written indemnity agreements and certificates of insurance from them. Elder requested independent counsel, which CastlePoint refused. Elder sued, the superior court concluded that he was entitled to independent counsel, and the court of appeal affirmed.

This reservation raised the question whether those who did the work were employees or independent contractors. Schaeffer had alleged that Elder acted through his employees, but Schaeffer had stated in interrogatory answers prepared by the counsel appointed by CastlePoint that he had primarily contracted with subcontractors to construct the house. CastlePoint argued that these facts created no conflict, because Elder would be liable for Schaeffer’s damages regardless of the status of the workers, so that would not be determined in the action. The court of appeal disagreed. “Schaefer must establish that those who provided the defective workmanship were related, in a business sense, to Elder. The determination of that relationship will impact, later in the declaratory relief action, whether the contractor’s special condition comes into play.” On that point, counsel “had an ethical duty to Elder to try to establish that the workers were employees and, at the same time, had an ethical duty to CastlePoint to try to establish that the workers were independent contractors.” On its own terms, this seems questionable, because the factfinder seemingly would have no occasion to determine what the relationship was. Nonetheless, the development of the evidence on this issue in the current action would necessarily impact on a later coverage action. (One may wonder why the issue was being litigated, as it appears to have no bearing on liability in the current action, but it apparently was being litigated, for whatever reason.)

[3] Cross-Insureds

Similar problems can arise in situations where two of the carrier’s policyholders assert covered claims against one another based on the same incident or where two policyholder

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50.3 There is no indication whether Elder had obtained indemnity agreements and certificates of insurance, but the fact that the issue was litigated suggests that he had, at least arguably, failed to do so in one or more instances.

50.4 217 Cal. App. 4th at 8.

50.5 217 Cal. App. 4th at 8.

51 E.g.: 


CA—*O’Morrow v. Borad,* 27 Cal. 2d 794 (1946);
defendants have inconsistent defenses.\footnote{MS—Moeller v. Am. Guar. & Liab. Ins. Co., 707 So. 2d 1062, 1072 (Miss. 1996).}

The simplest form of conflict between policyholders arises when they assert claims against one another. The leading case of this type is \textit{O'Morrow v. Borad}.\footnote{E.g.: Metlife Capital Corp. v. Water Quality Ins. Syndicate, 100 F. Supp. 2d 90, 93–94 & n.3 (D.P.R. 2000); Murphy v. Urso, 88 Ill. 2d 444, 452–55 (1981).} The two policyholders, through personal counsel, asserted claims against one another arising out of the same accident. Both were insured by Firemen’s Fund (and an affiliated carrier that will be disregarded here). Firemen’s Fund sought to select and direct defense counsel for O’Morrow, who asserted a right to control his own defense. O’Morrow sought a declaratory judgment, and the trial court concluded that he had breached the conditions of the policy by refusing to permit Firemen’s Fund to defend. The California Supreme Court reversed, reasoning that:

\begin{quote}
It is contrary to public policy for a person to control both sides of litigation. True, the insurers seek only to direct the respective defenses of the parties, but the issues of negligence and contributory negligence cannot be separated. These issues require the presentation of evidence by means of the same witnesses, and although the insurers propose to retain different counsel for each policyholder, through their respective attorneys the companies would have access to all information in regard to the entire case. Under the terms of the policy contracts, the insurers have undertaken to pay any judgment rendered in favor of either the plaintiff or the cross-complainant; they, therefore, have a pecuniary interest in effecting a balance between the litigants and so conducting the litigation that neither party recovers against the other … . Certainly a full and fair judicial examination of the merits of a case cannot be had when one person controls counsel for both sides.\footnote{CA—\textit{O’Morrow}, 27 Cal. 2d 794.} \\
\end{quote}

In light of the conflict of interest, the policyholder was excused from having to allow the carrier to control the defense, but the carrier remained obliged to pay for the reasonable cost of that defense.\footnote{CA—27 Cal. 2d at 798–99.}

This problem arises even where both policyholders are defendants, if there are cross-
claims between them. These can include cross-claims based on commercial indemnification agreements or common-law indemnity rights.57

Looking at the cross-insured problem generally, whenever a carrier defends two or more policyholders in the same matter, there will be a material limitation conflict if the policyholders are adverse to one another or if they have adverse interests on any issue implicated in the defense of each. In such circumstances, the carrier’s duty to each policyholder to provide the most effective defense will be materially limited by its corresponding duty to the other policyholder. Moreover, because the carrier ordinarily will be obliged to pay any judgment (up to the policy limits) against either policyholder, it will have direct financial interests in the outcome of the litigation. Typically, it will have greater exposure on one of the claims than on the other, with a resulting incentive to favor the defense of the policyholder for which it has greater exposure. That interest also creates a material limitation conflict with the policyholder whose claim involves the lesser exposure. For purposes of judging relative exposure, UM/UIM claims must be taken into account. (See § 6.04[5] below.)

The primary source of conflict in a two-policyholder cross-insured case can be removed if one policyholder asserts no claims against the other (and no UM/UIM claim based on the other’s alleged negligence). Typically, this would occur only in cases where it is clear that this policyholder bears 100% of the fault for the accident which is the subject of the lawsuit (or where this policyholder’s share of the fault is so great and this policyholder’s damages are so small that it is not worth pursuing an affirmative claim). In such circumstances, there is no need to provide any defense to the policyholder who bears none of the fault, so there would be no duty to that policyholder that would materially limit the defense of the at-fault policyholder. Moreover, as long as the carrier is prepared to concede 100% liability on the at-fault policyholder, the only issue to be litigated would be damages.

If any damages are clearly within the applicable policy limit, then the carrier alone would bear any risk at trial of that issue, and the at-fault policyholder usually would have no economic interest that could be injured by the result of the litigation. (Even if the damages might exceed policy limits, the carrier’s interests in resisting the claim would be aligned with those of the at-fault policyholder whom it would be defending in the same way as in a case with excess exposure but involving a claimant not insured by it.) While the policyholder who bears none of the fault might also have a UIM claim, the fact that liability would not be at issue prevents that claim from creating any conflict with the defense of the at-fault policyholder. Indeed, the existence of UIM coverage for the policyholder who is not at fault would indirectly protect the at-fault policyholder against excess exposure. The carrier would pay any excess judgment up to the applicable UIM limit and presumably would not seek recovery of that amount from the at-fault policyholder.

[4] Multiple Policyholders with Inconsistent Defenses
Another type of conflict between policyholders occurs when they have inconsistent

defenses. A leading case is *Murphy v. Urso*.\(^{58}\) Murphy was injured when the van in which she was riding struck several parked cars while traveling at excessive speed. The van was driven by James Clancey and owned by Marilyn Urso, owner of a pre-school and primary school. Urso maintained that Clancey had been fired as an employee of the schools and had no permission to use the van. Travelers defended Urso and refused to defend Clancey, who suffered a default judgment of $750,095. Murphy then brought this garnishment action against Travelers. The circuit court held that Clancey did not have permission to use the van (resulting in summary judgment for Urso), but that Travelers had breached its duty to defend Clancey and was estopped to deny coverage.

The Illinois Supreme Court held that Travelers owed a duty to defend, but was excused from defending by the existence of a conflict of interest. There was clear coverage for Urso and the schools and the contested issue of permission to use the van left a potential for coverage of Clancey, so there was a duty to defend both policyholders. But the interests of the policyholders conflicted:

An analysis of the possibilities reveals the dilemma in which Travelers found itself. It controlled both defenses. To best defend the preschool, it would try to show that Clancey did not have permission to use the bus at the time of the accident. To do this, it had to show either that he had been discharged or in any event was not operating within the scope of his employment, or that he had no explicit or implicit approval to use the bus. This would sever any connection between the preschool and Clancey, place all the liability on Clancey, and exonerate the school. But to best serve Clancey, Travelers had to try to show that he did have permission to use the bus. This would spread the liability to the schools. It was in Clancey’s interest, then, to show that he had not been fired and that his use of the bus was within the scope of his employment, or that he had received approval for the use of the bus to help Ms. Murphy move.\(^{59}\)

This conflict excused Travelers’ duty to defend (though not its duty to fund a defense) and obviated any estoppel.\(^{60}\) While the principle that inconsistent defenses create a conflict is clearly

\(^{58}\) IL—*Murphy v. Urso*, 88 Ill. 2d 444 (1981).

\(^{59}\) IL—88 Ill. 2d at 453. In fact, Clancey had no tort-law interest in inculpating the schools: if he were acting within the scope of an agency, he would still be obliged to indemnify his principal against liability for his own negligence. But, showing permission to use the van was essential to obtaining insurance coverage, so his interests were still inconsistent with the schools’ defense. And his coverage interests did create a defense-related conflict with Travelers. *See* § 6.04[1][b][ii].

\(^{60}\) IL—88 Ill. 2d at 454–57.

*See:*
correct, it is arguable that the analysis of whether there was an inconsistency in *Murphy* is more complicated than the court realized. (See § 6.04[8], below.)

A particularly common form of inconsistent defense is an effort by each defendant to ascribe more fault to the other than the other acknowledges. Not only is it a conflict for defense counsel to undertake representation of policyholders with inconsistent defenses, but a carrier’s knowing assignment of common counsel despite such a conflict can expose it to bad faith liability. Such a conflict is even more dangerous if the carrier is itself one of the defendants with conflicting interests. But a conflict of this sort can be eliminated if the carrier has sufficient limits to commit to fully indemnify each of the policyholder defendants, thereby removing any need to contest degrees of fault.

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**US/SC**—Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co. of S. Carolina, 433 F.3d 365, 374–75 (4th Cir. 2005) (inconsistent defenses entitled one defendant to independent counsel, but defendant forfeited that right by breaching duty to cooperate);

**US/PR**—Metlife Capital Corp. v. Water Quality Ins. Syndicate, 100 F. Supp. 2d 90, 93 n.3 (D.P.R. 2000) (“One of the most common conflicts of interest presented in the context of liability insurance is when the insurer insures two or more insureds with adverse interests. In such cases, it is generally accepted that in order to comply with its duty to defend the insured, the insurer must either retain or authorize the insured to retain independent counsel at the expense of the insurer.” (citations omitted)).


Note that there would be no conflict on the permissive use issue if that issue were not contested.


A curious application of this rule is found in *Country Mutual Insurance Co.*, 391 Ill. App. 3d 295, 302-05 (2009), where the two insureds had conflicting defenses, but the insurer had refused, incorrectly, to defend one of them on the ground that he had intentionally inflicted the injuries at issue; it is not clear what the conflict added to the conclusion that the refusal to defend was improper.


**US/MS**—Davenport v. St. Paul Fire & Marine Ins. Co., 978 F.2d 927, 932 (5th Cir. 1992);

**CA**—Spindle v. Chubb/Pac. Indem. Grp., 152 Cal. Rptr. 776, 778–81 (Cal. Ct. App. 1979) (same principle holds true even if two insureds are insured by the same carrier under separate policies with different
A particularly egregious case involving parties with inconsistent defense interests was presented in *Mosier v. Southern California Physicians Insurance Exchange*, with the twist that one of the parties was uninsured. Dr. Jouvenat delivered Ashley Hughes at Pomona Hospital. In the delivery, he twisted her neck 180 degrees, resulting in severe spinal injury that ultimately rendered her a ventilator-dependent quadriplegic. The hospital’s neonatologists, Drs. Hsu and Wu took over her care and misdiagnosed the problem, thereby missing the opportunity to take actions that might have greatly mitigated the damage. Dr. Jouvenat’s insurance had lapsed and, when reinstated, did not cover this incident. All of the other parties were insured by the Exchange (“SCIPE”).

In the ensuing malpractice action, Dr. Jouvenat initially was represented by counsel who withdrew when his fees were not paid. The defendants other than the three doctors named above settled. SCIPE decided to offer Dr. Jouvenat a “courtesy defense,” on the clear understanding that it would have no duty to indemnify. On the recommendation of the lawyer, Dr. Jouvenat admitted liability, defending only on damages; he conducted a joint defense with Drs. Hsu and Wu. The jury found Dr. Jouvenat 70% at fault and Drs. Hsu and Wu each 15% at fault, resulting in a net judgment against Dr. Jouvenat of $9,849,184 plus costs.

Dr. Jouvenat filed for bankruptcy and Mosier was appointed trustee of his estate. Mosier sued SCIPE and obtained a verdict of over $4 million in compensatory damages and $65 million in punitive damages for fraud and conspiracy to breach fiduciary duty. The trial court reduced the punitive damage award to $15 million. The court of appeal found culpability proven but damages unproven, setting aside the judgment.

Dr. Jouvenat was owed a defense free of conflicts, and he was never asked to waive that right. He was never told, as he should have been, that it was in his interest to attack Drs. Hsu and

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68 CA—63 Cal. App. 4th at 1039.


70 CA—63 Cal. App. 4th at 1048–53.
Wu for failure to mitigate the harm, rather than to conduct a joint defense with them. The joint defense potentially limited the allocation of fault to them and, thereby, the indemnity due from SCIPE, and that was what SCIPE sought to accomplish. Dr. Jouvenat’s lawyer, Forgey, had a long relationship with SCIPE and kept in closer contact with SCIPE than with Dr. Jouvenat. But inadmissible evidence had been submitted to the jury on damages and the admissible evidence failed to prove that Dr. Jouvenat could have accomplished anything by joining in the attack the plaintiff had made on Drs. Hsu and Wu, so there was no proof of injury resulting from the misconduct.

In jurisdictions permitting direct actions, both coverage and liability issues can be presented in the same case. If the carrier disputes coverage, its defense is necessarily inconsistent with the policyholder’s interests, precluding joint representation of carrier and policyholder. If the carrier appoints joint counsel for itself and the policyholder and the policyholder provides information to that defense counsel bearing on coverage, the carrier may then be estopped to deny coverage. Accordingly, carriers should be cautious in assigning joint counsel in direct actions.

Unsupported assertions of conflicts among multiple defendants do not require provision of separate counsel, and the carrier acted properly by assigning separate counsel once a concrete possibility of conflict was identified. Moreover, even if delay in providing separate counsel had been a breach, it caused no damage to the policyholder, because all defense costs and liability payments were paid under the available insurance coverage.


When a driver-policyholder has a UM/UIM claim based on the alleged negligence of another driver, who is not a policyholder, and the latter also asserts a claim against the former, conflicts can exist that resemble those that arise when two policyholders covered by the same carrier sue each other. In fact, if the claim is a UIM claim, the second driver may be covered by

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CA—63 Cal. App. 4th at 1044–47.

CA—63 Cal. App. 4th at 1048–53.

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TX—409 S.W.3d at 815.
The leading case addressing such a conflict is *Nationwide Mutual Insurance Co. v. Webb.* The issue in that case was the permissibility of a policy provision that the carrier would not be bound by a judgment in a suit by the policyholder against an uninsured motorist unless it consented to that suit. One of the reasons Nationwide advanced for permitting such a provision was the risk of conflicts for a carrier involved in such a suit. In rejecting that argument, the court reasoned:

> We agree with the insurance company that a conflict of interest may arise because of the uninsured motorist coverage. *Thus, in defending against its insured in the tort action, the insurer might seek to establish that the policyholder was contributorily negligent and/or that the uninsured motorist was free of negligence. On the other hand, if the uninsured motorist has or may have a claim against the policyholder, the carrier has a duty of defending its insured under the liability provisions of the policy and, in that connection, might want to show exactly the opposite, i.e., that the policyholder was not negligent and/or that the uninsured motorist was negligent.* However, the potential for a conflict of interest does not arise simply because the “consent to sue” clause is invalid. Rather, the potential for such conflict is inherent in uninsured motorist coverage. Furthermore, the danger of conflict exists in other insurance situations, such as when the plaintiff and defendant in a tort case have the same liability insurer, or when the plaintiff in a tort case presents claims against the policyholder which are both within and without the policy coverage. Such conflicts, if they occur, are resolved by having the insurer provide an independent attorney to defend the policyholder against any liability claims.

The facts in each case must be carefully analyzed to determine whether there is any substantial basis for concluding that the carrier has an interest that could be served by an impaired defense. If so, independent counsel should be provided.

#Comment Begins

Example 3:

Policyholder was in an accident with an Uninsured Driver. There is considerable evidence of fault on each side. Uninsured Driver suffered modest injuries, probably valued at less than $25,000, while Policyholder suffered serious injuries, probably valued in excess of $100,000. Policyholder has $50,000 per person bodily injury and UM limits. Because the amount at stake on the UM claim exceeds that on the claim against the policyholder and comparative fault will be a critical issue on both claims, there is a conflict of interest and the policyholder is entitled to

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78 *291 Md. at 740–41* (emphasis added, citations omitted).
independent counsel.

#Comment Ends#Comment Begins
Example 4:
Policyholder was in an accident with Uninsured Motorist and clearly had considerable fault. There is some evidence of fault on the part of Uninsured Motorist, but much less than that of Policyholder. Policyholder suffered modest medical bills and a little lost wages. Uninsured Motorist suffered only soft tissue injuries, but claims severe pain. Medical evidence on those injuries is very equivocal. Policyholder has a $250,000 per person liability limit. Because the major issue in Uninsured Motorist’s suit will be damages and the amount at stake is considerably greater than on Policyholder’s (weak) UM claim, an impaired defense of Uninsured Motorist’s suit would harm the exposure under the liability policy. Carrier can therefore be expected to defend Policyholder vigorously. Independent counsel is unnecessary.

#Comment Ends

As these examples illustrate, it may be unclear at the outset whether a UM claim creates a conflict of interest, because the analysis may turn on as yet unknown information about liability and damages. Ordinarily, such a case may be undertaken by assigned counsel, as long as there is prompt development of the information necessary to determine whether a conflict exists without any substantial possibility that counsel will be called upon to take action that could be detrimental to the policyholder. (For example, facts regarding the plaintiff’s injuries can be developed by defense counsel and the facts regarding the policyholder’s injuries may be presented by the policyholder or the policyholder’s counsel in asserting the UM claim; liability facts may be or may become sufficiently evident without action by defense counsel (e.g., from the accident report, investigation by the adjuster, or presentation by plaintiff’s counsel). If a conflict is found or if, after initial factual development, it remains unclear whether there will be a conflict, counsel should consult with both the policyholder and the claim representative. Until it is determined that there is no conflict, counsel should refrain from making strategic or tactical choices that will irreversibly shape the defense and limit the options of any successor counsel.

Policy limits sometimes depend on the nature of the liability found against the policyholder. Such differential limits can create conflicts of interest, as they did in Ladner v. American Home Assurance Co. Dr. Ladner, a psychologist, was sued for negligently treating, testing and counseling a patient and for sexual misconduct with that patient. American Home provided malpractice coverage of $1,000,000, but claims for “erotic physical contact” were subject to a $25,000 limit. The court found a conflict, making independent counsel necessary:

[C]ounsel for [Ladner] could conceivably decide that the best defense would be to argue that, as a factual matter, the allegations of sexual misconduct were untrue, while less

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NY—201 A.D.2d at 302.
vigorously contesting the allegations of other types of malpractice. Such an outcome would be beneficial to [Ladner], since any damages arising out of the malpractice would in that case be subject only to the $1,000,000 limit, but for the same reason would not be beneficial to [American Home]. Clearly, such tactical decisions should be in the hands of an attorney whose loyalty to [Ladner] is unquestioned and not an attorney employed by [American Home] with a potential for a conflict of interest. 81

[7] Davalos: Possible Conflicts Regarding a Policyholder’s Affirmative Claim

In Northern Country Mutual Insurance Co. v. Davalos, 82 the Texas Supreme Court rejected a claim that a dispute between a carrier and a policyholder about venue created a conflict requiring independent counsel. But, in some circumstances, some other courts might reach a different conclusion. So the case is worth some attention.

Davalos, a resident of Matagorda County, had an accident in Dallas County. He sued the other driver in Matagorda County. The other driver sued Davalos in Dallas County. Davalos had his Matagorda County counsel (personal counsel) appear in the Dallas County action and move to transfer to Matagorda County. Davalos then tendered the defense of the action against him to Northern. Northern offered to provide defense counsel, with the expectation that such counsel would withdraw the motion to transfer. Personal counsel responded that Davalos was entitled to pursue the transfer motion and Northern’s position created a conflict, precluding Northern from directing the defense or selecting counsel.

Even though Northern was not permitted to take control, the Dallas case was not transferred. Instead, on the motion of another party, the Matagorda County case was transferred to Dallas. Northern then settled the claim against Davalos, at no cost to him. Davalos sued Northern for breach of contract and bad faith. The trial court granted summary judgment for Davalos on liability and the parties stipulated to the amount of damages (presumably the defense costs paid by Davalos). The court of appeals affirmed, holding that Northern had breached its duty to defend. 83 The Texas Supreme Court granted review and reversed.

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NY—201 A.D.2d at 304. See

US/CA—Scottsdale Ins. Co. v. Housing Group, 1995 U.S. Dist. LEXIS 8791, at *11–14 (N.D. Cal. 1995) (real estate developer’s policy had lower sublimit for claims caused or aggravated by earth movement, and causation issue created conflict with policyholder);

IL—Continental Casualty Co. v. Grossmann, 271 Ill. App. 3d 206, 212 (1995) (amount of coverage depended on whether alleged acts of malpractice were related or unrelated, which would depend on facts shown by evidence in tort case).

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Davalos asserted that Northern had imposed an improper condition on its offer of a defense. The supreme court disagreed. In general, a carrier’s “right to conduct the defense includes the authority to select the attorney who will defend the claim and to make other decisions that would normally be vested in the insured as the named party to the case.”\textsuperscript{84} In some circumstances, a carrier is prevented from insisting on its right to control the defense, but that right would be illusory if any disagreement with the policyholder about the handling of the case were deemed to create a conflict entitling the policyholder to take control.\textsuperscript{85} Usually, a conflict arises from a carrier’s reservation of the right to deny coverage based on asserted facts that will also be at issue in the case against the policyholder.\textsuperscript{86} Additionally, “the insured may rightfully refuse an inadequate defense and may also refuse any defense conditioned on an unreasonable, extra-contractual demand that threatens the insured’s independent legal rights.”\textsuperscript{87} So, for example, Northern could not properly have demanded Davalos dismiss his own action before he could receive a defense of the action against him.\textsuperscript{88}

Davalos contended that Northern had asserted an intent to interfere with the defense of the action by instructing defense counsel to withdraw the motion to transfer. But it was Davalos, not Northern, who prevented the defense counsel selected by Northern from exercising independent judgment about the venue motion, because Davalos refused to arrange transfer of the defense to that counsel. Had he done so, he could have submitted that issue to the counsel, who would have had an unqualified duty of loyalty to Davalos and would have been bound to protect his interests.\textsuperscript{89} Moreover, in the court’s view, venue would rarely, if ever, “amount to a disqualifying conflict”:

The county where a covered claim should be defended is a strategic litigation decision that must be made in conducting the insured’s defense. The choice of venue should ordinarily have no


\textsuperscript{85}TX—140 S.W.3d at 688.

\textsuperscript{86}TX—140 S.W.3d at 689.

\textsuperscript{87}TX—140 S.W.3d at 689.

\textsuperscript{88}TX—140 S.W.3d at 689.

\textsuperscript{89}TX—140 S.W.3d at 689–90.
impact on the insured’s legitimate interests under the policy.90

While Davalos had the right to reject Northern’s tender of defense, because he did not want the case defended in Dallas County, he had no right to have Northern pay for personal counsel to defend.91

The Texas court chose to treat venue as solely an issue of convenience: how close would the courthouse be to the policyholder. But Davalos had a basis for arguing that there was more involved. It was likely that the two cases would be consolidated, as they ultimately were. Matagorda County is widely regarded as an especially favorable venue for plaintiffs, while Dallas County is regarded as a favorable venue for defendants. On that basis, while consolidation of the cases in Dallas County might be good for the defense of the case against Davalos, it might be equally bad for Davalos’s case as a plaintiff. Accordingly, Davalos could argue that his interests as a plaintiff would be harmed by withdrawal of the motion to transfer.

Some courts might accept such an argument in at least some cases where the policyholder has an affirmative claim. Moreover, there may be other circumstances where decisions advantageous to defense of the claim against the policyholder might have some adverse impact on the policyholder’s affirmative claim. How ought such matters to be handled?

The policyholder does not need to give up or compromise an affirmative claim in order to maintain its rights under an insurance policy. The defense lawyer should make strategy decisions consistent with the policyholder’s overall interest in the litigation, which would mean taking into account the effect of a defense decision on the policyholder’s affirmative claim. The defense counsel should defend the claim against the policyholder in cooperation with the policyholder’s personal counsel who is handling the affirmative claim, and personal counsel can be relied upon to call attention to any risk of impact on the affirmative claim. Accordingly, there is no need to deny the carrier the right to select defense counsel.

In the vast majority of the cases, the defense lawyer and the lawyer hired on the affirmative claim would work together to reach a mutually beneficial result. (Of course, the carrier has a right to be involved in the decision-making process.) In the extraordinary case in which the policyholder and the carrier cannot agree on an important tactical decision about how the defense should be conducted and the tactical choice may adversely affect the affirmative claim, defense counsel will have to withdraw unless the carrier will defer to the policyholder on such matters. (The carrier may contend that the policyholder’s refusal to accept the carrier’s tactical decision breaches the policy and may endanger coverage, and the policyholder should be warned about that risk before forcing withdrawal.)

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TX—140 S.W.3d at 690.

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TX—140 S.W.3d at 690.
[8] Questionable Cases on Contested Course and Scope of Employment

Contested course and scope of employment can create conflicts, either between the employee and employer or between the employee and the carrier. Two Illinois cases (one old, one new) suggest the existence of a conflict in circumstances where careful analysis leads to the opposite conclusion. Both cases actually involved conflicts (on other grounds), so they are arguably distinguishable from one presenting only the questionable conflict they assert. Nonetheless, their questionable conflict proposition may now be the law of Illinois, and policyholders in other states may rely on those cases to argue for independent counsel.

The cases in question say that there is a conflict of interest when (1) plaintiff sues an allegedly negligent employee and asserts that the employer is vicariously liable and (2) the employer denies that the employee was acting in the course and scope of employment. The more recent case is the Illinois Appellate Court’s decision in Williams v. American Country Ins. Co. 92

Williams was a cabbie. A police officer, Davila, was leaning in the passenger door of Williams’ cab to reprimand him for blowing his horn. Williams drove off, injuring Davila. Davila sued both Williams and Yellow Cab, alleging agency. Williams was a permissive user, even if an independent contractor, so he was clearly a policyholder. American Country, a carrier affiliated with Yellow Cab, reserved the right to deny coverage for intentional injury. It also appointed joint defense counsel for Williams and Yellow, who filed an answer (and, later, discovery responses) denying agency. At some point, Williams was convicted of misdemeanor battery.

Williams demanded independent counsel and sued to get it. The carrier counterclaimed for a declaration of no coverage, based on the criminal conviction establishing intentional acts. In due course, the appellate court agreed, but remanded for a determination whether there was a conflict of interest entitling Williams to independent counsel and, if so, whether Williams had suffered prejudice estopping the carrier from denying coverage. The circuit court found that there was coverage, that there had been prejudice, and that the carrier had vexatiously denied benefits, awarding $125,000 in attorney’s fees and a penalty of $25,000. The appellate court affirmed.

The appellate court reasoned that the denial of agency would harm Williams by preventing him from “spreading” the loss to Yellow. It relied on Murphy v. Urso, 93 where the Illinois Supreme Court said the same thing.

Viewed purely as a matter of conflicts logic, Williams had no interest in the agency issue. A finding of agency permits the plaintiff to collect from the cab company, but does not “spread” the liability between the driver and the company. If the company is vicariously liable, the driver will be obliged to indemnify it. As a matter of tort law and as between the company and the driver, the entire liability should fall on the driver if the driver’s conduct is the basis for liability. The driver will be liable, regardless of agency, so agency really makes no difference in the driver’s liability. In particular, there was no question that Williams was a permissive user of the cab and, so, a policyholder. Agency was not a coverage issue as to Williams, bearing only on the


company’s liability.

But there actually was a conflict, of a different sort. There were (seemingly insubstantial) allegations in the complaint that the cab had defective brakes and steering. If liability were found on that ground, Yellow would be directly liable and obliged to indemnify the driver. Consequently, the ground of liability makes a difference between the two policyholders and defending both is a conflict of interest. Even if the carrier were not affiliated with Yellow (which it is), that would entitle the driver to independent counsel.

The same logic also shows that Yellow was entitled to independent counsel, if it wanted that (unlikely, in these circumstances). Additionally, the agency issue was a conflict for the cab company. If the driver were an agent and if his intent were imputed to Yellow, there would be no coverage. So the carrier could have an incentive to pull its punches in defending the agency claim, were it not an affiliate of Yellow.

Moreover, the intentional acts reservation ordinarily creates the paradigmatic insurance defense conflict. The carrier here says that didn’t matter, because intentionality was not an issue in the tort suit. The court did not address that issue, and doing so is unnecessary under either this analysis or that of the court. In ordinary circumstances, it likely would create a conflict, despite the narrower issues in the tort action: litigation of the negligence issue would necessarily involve exposure of defense counsel to otherwise confidential information bearing on intentionality. (See § 6.04[1][b][ii] above.) But the early criminal conviction in Williams probably takes all of that out of the analysis (and probably limits the issues in the tort case to damages, as to which there is no conflict). That might have eliminated the conflict on that issue, but one would need to know more facts (e.g., when did the conviction occur).

In the end, the conflicts result in Williams is right, even though the reasoning seems wrong. The same is true of Murphy (which similarly made the mistaken assertion that a finding of agency would have permitted spreading of the loss to the vehicle owner). In Murphy, the owner denied both agency and permission to drive, claiming it had fired Murphy. Permissive use was a coverage defense and an agency finding would have established permissive use. So Murphy did have an interest in the agency issue, despite the indemnity obligation to his employer that would have accompanied that finding. Accordingly, there was a pivotal issue, creating a conflict.

While both Williams and Murphy could and should be decided the same way, regardless of whether the agency issue itself created a conflict regarding the driver’s defense, future Illinois courts may treat as binding their statement that the agency issue created a conflict. Risk management suggests treating it that way unless the issue can be litigated before independent counsel is denied.

In other states, the question will be whether the local courts are likely to duplicate the analytic mistake of the Illinois courts. One hopes most courts would not, at least if the error were pointed out. But some New York state trial courts have made the same error in cases where an injured party sued both a car rental company and the renter, alleging, inter alia, vicarious liability or negligent entrustment, either of which would entitle the rental company to indemnity from the renter, and where there was no coverage issue.²

[9] Excess Exposure Generally Does Not Create a Conflict

“[A] damage claim beyond policy limits in and of itself presents no ethical problem to the lawyer employed to defend the case, because his employment is for one of two purposes: either win the case outright, or keep the damages as low as possible. Everything he does in fulfillment of either objective must of necessity benefit both [insurer and policyholder].” The Restatement of the Law of Liability Insurance agrees that the fact that a claimant seeks damages in excess of the applicable limits of coverage provided by a liability insurance policy does not, in itself, oblige the insurer to provide an independent defense.

Still, carrier and policyholder can have differing interests regarding settlement whenever the policyholder has excess exposure, and counsel must act carefully in dealing with that subject. (See § 12.05[5], below.) But counsel does not control settlement and is not liable for failing to persuade the carrier to make a more generous settlement offer (or any at all). The remedy for improper failure to settle is a later suit against the carrier for that conduct. The efficacy of this remedy is demonstrated by the fact that, even in the area of medical malpractice, where defendants typically have substantial personal assets that could theoretically be reached to satisfy excess judgments, defendants contribute personal assets to settlements in fewer than one percent

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MS—Hartford Accident & Indem. Co. v. Foster, 528 So.2d 255, 269 (Miss. 1988). See also:

US/IL—Littlefield v. McGuffey, 979 F.2d 101, 108 (7th Cir. 1992);

US/NY—N.Y. Marine & Gen. Ins. Co. v. Lafarge N. Am., Inc., 599 F.3d 102, 125 (2d Cir. 2010) (even excess exposure that threatened insured’s existence did not create conflict);

US/PR—Metlife Capital Corp. v. Water Quality Ins. Syndicate, 100 F. Supp. 2d 90, 94 (D.P.R. 2000);

AK—ALASKA STAT. §§ 21.96.100(b) & (c);

CA—CAL. CIV. CODE § 2860(b);


95 RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 16, cmt. c (Prop. Final Dr. No. 1 Mar. 28, 2017) (“A demand for damages in excess of the applicable policy limits creates a potential conflict of interest between the insurer and the insured. Insurance law addresses this conflict through the duty to make reasonable settlement decisions, however, so independent counsel is not ordinarily required.”) (Citation omitted.).

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US/KS—Kannaday v. Ball, 2014 U.S. Dist. LEXIS 120755, at *35-36 (D. Kan. Aug. 29, 2014) (in failure to settle case, court rejected argument that carrier's interests conflicted with those of the policyholder on the ground that the policyholder was an insolvent estate whose nonexistent assets were fully protected by a nonclaim statute before any suit was filed).

97 See RESTATEMENT, § 16, cmt. c.
of the cases.\textsuperscript{98}

In \textit{Allstate Insurance Co. v. Campbell},\textsuperscript{99} the policyholder claimed that the carrier’s rejection of a demand within limits created a conflict, entitling him to reimbursement of the fees of counsel he retained to monitor defense and settlement. The Maryland Court of Appeals disagreed: “it is unreasonable to allow an insured, dissatisfied with the progress of settlement negotiations, to retain counsel either to monitor or attempt to take over the defense, and then require the insurer to reimburse the insured for the cost of that counsel.”\textsuperscript{100} In its view:

An insurer’s decision to reject, initially, an offer of settlement within the insured’s policy limits is not enough, in itself, to create a conflict of interest as would require the insurer to give up direction of the defense of the insured.

“Since the insurer’s decision [to reject a settlement offer] merely preserves and does not create the conflict of interests between the parties, it makes little sense to treat this decision as the basis for wresting from the insurer both the responsibility for and the right to continue to conduct the defense, including decisionmaking regarding the possibilities for settlement which may subsequently occur.”

The insurer remains bound by a continuing duty to negotiate in good faith to settle the claim within policy limits. If the insurer should ultimately violate its duty regarding settlement, the insured’s remedy lies in a tort action against the insurer for a bad faith failure to settle.\textsuperscript{101}

Courts have found conflicts entitling policyholders to independent counsel in some unusual cases excess exposure cases. For example, in \textit{Golden Eagle Insurance Co. v. Foremost Insurance Co.}\textsuperscript{102} the carriers agreed to a settlement calling for payment of what they claimed were their applicable policy limits of $4,000,000 plus $250,000 from the nonconsenting policyholder; Golden Eagle also newly asserted a claim that one of its policies (included in the


\textsuperscript{99} MD—\textit{Allstate Ins. Co. v. Campbell}, 334 Md. 381 (1994).

\textsuperscript{100} MD—334 Md. at 397.


$4,000,000 commitment) was not applicable, based on the loss-in-progress rule. The policyholder retained independent counsel. The carriers then asked the court in which the suit was pending to approve the settlement, presenting that request by their own counsel. While the policyholder opposed the settlement, defense counsel recommended it to the court. In this circumstance, defense counsel’s obligations to the carriers rendered representation of the policyholder less effective, creating a conflict warranting independent counsel.

[10] But the Seventh Circuit Has Held That a Sufficient Risk of an Excess Judgment Sometimes May Create a Conflict


In R.C. Wegman Construction Co. v. Admiral Insurance Co., the Seventh Circuit found what it deemed a conflict based on excess exposure. That conclusion seems highly questionable. The issue in the case was whether the primary carrier should have conveyed more information about the policyholder’s potential exposure, which, had it been provided, might have alerted the policyholder to notify its excess carrier. The opinion offers no basis for thinking that a conflict existed concerning either the provision of the relevant information or the desirability of notifying the excess carriers. That said, the result in the case can be defended on other grounds.

R.C. Wegman Construction Co. (“Wegman”), a construction manager, was sued for injuries suffered by Brian Budrick (“Budrick”), an employee of Standard-Hayes Boiler & Tank, LLC (“Standard”), one of the contractors working at the site. Standard’s $1 million policy with Admiral Insurance Co. (“Admiral”) named Wegman as an additional insured and Admiral defended. Wegman was also an additional insured under a $10 million excess policy issued by American International Specialty Lines Insurance Co. (“AIG”). AIG was not notified of the claim until just before the trial in September, 2007 and denied coverage for want of timely notice.

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CA—20 Cal. App. 4th at 1377–78, 1390–91, 1393. (Agreeing to commit policyholder funds would seem improper on the ground that the carriers had no authority to do that. William T. Barker & Ronald D. Kent, NEW APPELLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 2.06[2]. But that point was not addressed in the opinion.)

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CA—Golden Eagle, 20 Cal. App. 4th at 1394–96. See also

OH—Swiss Reinsurance America Corp v. Roetzel & Andress, 837 N.E.2d 1215 (Ohio Ct. App. 2005) (carrier’s rejection of counsel’s recommendation to settle case with excess exposure created conflict of interest precluding continued representation of carrier, which therefore could not sue for malpractice). The court does not explain how the refusal to settle created a conflict regarding conduct of the defense, nor why the carrier ought not to be able to seek redress for any inflation of the eventual judgment resulting from the allegedly mishandled defense. After all, there was no finding that the refusal to settle had been improper; perhaps proper defense might have prevented the excess judgment.

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Judgment at trial was slightly more than $2 million, and Wegman brought this bad faith suit. According to Wegman, Admiral learned at Budrick’s deposition in May 2005 that there was a realistic chance of an award exceeding its policy limits. In April 2007, Budrick demanded $6 million to settle. Admiral never told Wegman either of these things, so Wegman did not notify AIG until just before trial. The primary claim was that Admiral should have notified Wegman of the risk of excess exposure.

The district court concluded that Illinois recognizes a duty of good faith in managing the defense and settlement negotiations, which can be breached by failure to settle within limits or by picking an unduly risky defense strategy. But, in the court’s view, Wegman did not allege any breaches of that sort. (Wegman disputed that point, but the Seventh Circuit did not address the dispute.)

Wegman argued that failure to notify the policyholder of possible excess exposure creates risks similar to refusing a within-limits settlement, so the duty of good faith should require such notice. But Wegman did not claim that Admiral could have done anything to prevent the excess judgment. Wegman claimed only that, with notice, it might have retained independent counsel and could have notified its excess carrier. The district court concluded that that claim was “too attenuated to fit the [Illinois] courts’ circumscribed application of the duty of good faith.”

Moreover, the court found that “the duty of the insure[r] to consider the interest of the insured at least equal to its own is rooted in the possibility that a conflict of interest [regarding settlement] may arise where the insured is a defendant in a suit in which potential recovery may exceed policy limits.” But here, no conflict arose because there were no within-limits demands and the only demand was clearly excessive, so there was no reasonable prospect that Wegman might have wanted to accept that (and Wegman did not allege that it would have been interested in doing so).

The court further observed that Wegman had not cited any authority supporting a duty of the carrier to tell the policyholder what had occurred at a deposition or in anything other than settlement negotiations (which a single unreasonable demand did not constitute). Defense counsel

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US/IL—Some of the facts stated here are drawn from the district court’s decision, R.C. Wegman Constr. Co. v. Admiral Ins. Co., No. 08 C 6479, 2009 U.S. Dist LEXIS 22546 (N.D. Ill. Mar. 20, 2009), or from the appellate briefs.

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might have such a duty, but defense counsel were not sued and an Illinois carrier is not vicariously liable for defense counsel’s errors. Moreover, the very fact that the carrier had provided counsel who presumably did have a duty to keep Wegman informed counseled against imposing any duty to inform on the carrier itself.

As discussed in § 6.04[10][b] below, the Seventh Circuit reversed based on a supposed conflict of interest. But neither Admiral nor defense counsel had any reason to avoid providing notice to AIG. There is no discussion in the opinion of whether Admiral and defense counsel knew of the existence of the excess insurance (as there were no allegations in the complaint about that). But they must have been on notice of that. (Budrick’s counsel almost surely propounded discovery about insurance. And if Budrick’s counsel had thought that there was only $1 million in insurance, he would almost surely have made a $1 million demand.) Of course, Admiral and defense counsel probably did not know whether the excess carrier had been placed on notice. Indeed, the most likely explanation for failure to keep Wegman informed was an assumption that the excess carrier had been put on notice. Danger or not, failure to notify Wegman may well have been a breach of duty. But it involved no conflict of interest, because no one had any interest in preventing notice to the excess carrier.

[b] The Seventh Circuit’s Opinion

In an opinion by Judge Posner, the Seventh Circuit complained that “[n]either the briefs nor the complaint, nor for that matter the insurance policy, judicial opinions, or treatises on insurance law, tell us much about how situations of the sort presented by this case are handled by insurance companies.” So the court turned to “our own research.” That led it to the conclusion that “[t]he situation in question is the emergence of a potential conflict of interest between insurer and insured in the midst of a suit in which the insured is represented by a lawyer procured and paid for by the insurer.”

In a normal case (and on the facts here), there is no reason at the outset to anticipate an excess judgment, and this leads the carrier to manage the case as if it were the sole defendant. The court recognized that, under Illinois law:

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US/IL—629 F.3d at 727 (citing a variety of articles).

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US/IL—629 F.3d at 727.
“‘the insurer’s duty to defend includes the right to assume control of the litigation … to allow insurers to protect their financial interest in the outcome of litigation and to minimize unwarranted liability claims. Giving the insurer exclusive control over litigation against the insured safeguards the orderly and proper disbursement of large sums of money involved in the insurance business.’”

“By virtue of that control, however, the insurer’s duty to the insured includes not only ‘the hiring of competent counsel’ but also ‘keeping abreast of progress and status of litigation in order that it may act intelligently and in good faith on settlement offers.’”

Thus, Admiral presumably knew, shortly after Budrick was deposed in May 2005, of the facts indicating a genuine risk of excess liability. (Admiral was hoping to avoid that by keeping Wegman’s share of the fault under 25%, which would have made Wegman liable only for its share of the fault, but the jury found that Wegman had 27% of the fault, making it jointly and severally liable.)

In these circumstances, the court said, “[g]ambling with an insured’s money is a breach of fiduciary duty.”

That brought the court to the independent counsel issue:

When a potential conflict of interest between insured and insurer arises, the insurance company’s duty of good faith requires it to notify the insured. *The usual conflict of interest involves the insurance company’s denying coverage [citing cases], but the principle is the same when the conflict arises from the relation of the policy limit to the insured’s potential liability ... . Once notified by the insurer of the conflict, the insured has the option of hiring a new lawyer, one whose loyalty will be exclusively to him. If he exercises that option, the insurance company will be obligated to reimburse the reasonable expense of the new lawyer.* Had Wegman hired a new lawyer upon being promptly informed of the conflict back in May 2005, that lawyer would have tried to negotiate a settlement with Budrik that would not exceed the policy limit; and if the settlement was reasonable given the risk of an excess judgment, Admiral would be obligated to pay. And since Wegman had excess insurance, notification to it of the risk of an excess judgment would have enabled it to notify its excess

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US/IL—629 F.3d at 728 (internal citation omitted).

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US/IL—629 F.3d at 728.

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US/IL—629 F.3d at 729.
insurer promptly, in order to preserve the protection that the
excess coverage provided.\textsuperscript{120}

This appeared to assume that some unspecified conflict had created a right to independent
counsel, with the power of such counsel to negotiate a settlement simply being a consequence of
that right (and a basis for finding possible damage from failure to notify). The Illinois Insurance
Association, the American Insurance Association, and the National Association of Mutual
Insurance Companies filed an amicus brief on petition for rehearing that tried to caution the court
against assuming that independent counsel would have that power,\textsuperscript{121} but that brief concentrated
on the nonexistence of the supposed antecedent conflict and on alternate grounds that might have
supported a duty to notify.

[c] Supplemental Opinion

The Seventh Circuit denied leave to file the amicus brief and denied rehearing,\textsuperscript{122} filing a
short supplemental opinion which clarified its reasoning as follows:

Admiral’s petition for rehearing contends that we held that
“where there is a possibility of a verdict in excess of policy
limits, there is a conflict of interest between the insurer and the
insured.” This characterization ignores the facts that led us to
find a conflict (actually just alleged facts, since the complaint
was dismissed by the district court). We said that “the conflict in
this case arose when Admiral learned that an excess judgment
(and therefore a settlement in excess of the policy limits, as
judgment prospects guide settlement) was a nontrivial
probability in Budrick’s suit.” (emphasis added) Among the
facts supporting that characterization were (1) the nature and
severity of the plaintiff’s injury, (2) the settlement demand in
excess of policy limits, (3) the fact that the case had been slated
for trial (and in fact tried), (4) the plaintiff’s securing at trial an
award double the policy limit, (5) Admiral’s admission that its
primary litigating strategy was to downplay Wegman’s
responsibility rather than to deny liability, and (6) Admiral’s
failure to warn Wegman that it had adopted a strategy that placed
Wegman in jeopardy of an excess judgment. Admiral’s attorney
has admitted taking a gamble by proceeding to trial in hopes of a
ruling that Wegman’s share of liability was below 25 percent,
which would turn a $2 million damages award into a $500,000
award. Rather than being warned by Admiral, Wegman
discovered that the case was going to trial only through an
accidental conversation just days before the trial began.

\textsuperscript{120} US/IL—629 F.3d at 729 (emphasis added, citations omitted).
\textsuperscript{121} A co-author of this publication, William T. Barker, was the author of that brief.
The case is thus like *Nandorf, Inc. v. CNA Insurance Cos.* , which involved a compensatory damages claim and a punitive damages claim; the insured wanted to minimize its total liability while the insurer sought to minimize merely the compensatory damages claim because its insurance policy didn’t cover punitive damages. Admiral made a similar strategic move when faced with the likelihood of an excess judgment; instead of notifying Wegman and allowing it to negotiate its own settlement, or at least notify its excess-insurance carrier, Admiral’s lawyer gambled on obtaining a reduction in damages, on the basis of Illinois’ joint-and-several liability statute, that would bring the damages award against Wegman below Admiral’s policy limit. Admiral’s gamble created a conflict of interest that entitled Wegman to choose its own attorney to represent its interests, yet Admiral failed to warn Wegman of what it was doing. If Wegman can prove these allegations, it will have demonstrated a conflict of interest under Illinois insurance law.123

Admiral’s rehearing petition made a major point of arguing that it had not taken any gamble. Its defense strategy had not placed Wegman in jeopardy of an excess judgment: the facts of the case did that, and the defense strategy was the best chance of avoiding such a judgment. (Wegman never argued otherwise, and the Seventh Circuit offers no basis to question Admiral on that point.) Admiral was never presented with any opportunity to settle within its limits, so, it argued, the only thing it could do was try the case.

Of course, Wegman could have been protected against an excess judgment if notified of the risk and thereby warned of the need to place its excess carrier on notice. But, as pointed out in § 6.04[10][a] above, neither defense counsel nor Admiral had any interest in forestalling notice to the excess carrier.

Still, a conflict of interest on that point could have been found had there been no excess insurance and if, as the Seventh Circuit clearly assumes, the risk of excess liability would have freed Wegman to settle for policy limits. Because Admiral saw a possibility of holding the judgment to $500,000, its interest would have been to take the case to trial, even if there were a risk of an excess judgment. That would look like the classic settlement conflict, which appears to be what the Seventh Circuit thought it saw (having overlooked the way in which the excess insurance arguably eliminated any such conflict).

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US/IL—634 F.3d at 371–72. Despite the Seventh Circuit’s listing of multiple factors as the basis of its conflict finding, at least one district court has read it to indicate existence of a conflict, and a right to independent counsel, whenever there is a significant prospect of a substantial excess judgment. *Perma-Pipe, Inc. v. Liberty Surplus Ins. Corp.*, 38 F. Supp. 3d 890, 895 (N.D. Ill. 2014). In particular, the court rejected the effort to distinguish Wegman on the ground that Perma-Pipe, unlike Wegman, was fully aware of the risk of an excess judgment. 38 F. Supp. 3d 890, 895. Another district court has held that more facts are necessary, such as whether the insured is likely to be liable for all of the damage claimed or only part and whether other defendants are likely to cover enough of the claim to keep the loss within limits. *DePasquale Steel Erectors Inc. v. Gemini Ins. Co.*, 2017 U.S. Dist. Lexis 54917, at *9-10 (N.D. Ill. April 11, 2017).
Indeed, the original opinion explained the conflict in precisely those terms:

Suppose Admiral thought that if Budrik’s case went to trial there was a 90 percent chance of a judgment no greater than $500,000 and a 10 percent chance of a judgment of $2 million (to simplify, we ignore other possibilities). Then the maximum expected cost to Admiral of trial would have been $550,000 (.90 x $500,000 + .10 x $1,000,000, the policy limit), and so (ignoring litigation expenses) Admiral would not want to settle for any higher figure. But Wegman would be facing an expected cost of $100,000 (.10 x ($2,000,000 - $1,000,000)), and no benefit, from a trial.124

[d] Responses to Wegman

[i] Narrow Construction

An important consideration in Wegman is that it arose on a motion to dismiss. If there were any plausible set of facts consistent with the allegations of the complaint on which Wegman might have been able to recover, dismissal would have been improper and reversal required. While the Seventh Circuit suggested that reversal could be supported based on the possibility that a specified state of facts might be proven, the opinion was dictum to the extent that reversal would also have been required based on some narrower standard of liability consistent with the allegations in Wegman.

In particular, the court said that the conflict arose “when Admiral learned that an excess judgment (and therefore a settlement in excess of the policy limits, as judgment prospects guide settlement) was a nontrivial probability in Budrick’s suit.” But the facts described indicate a very substantial probability of an excess judgment. There was no serious contest of liability and seemingly the only hope of keeping the judgment within limits was to have a finding that Wegman bore no more than 25% of the fault for the accident (making its liability several, rather than joint and several). To the extent that the opinion suggests that some probability of excess liability less substantial than that evidently involved in Wegman might create a right to independent counsel, that suggestion is dictum, not binding in any future case.

The Seventh Circuit analogized the conflict that it saw as warranting independent counsel to the usual conflict created by the combination of excess exposure and an opportunity to settle within limits. And the facts alleged are consistent with the possibility that Admiral would have been obliged to accept a $1 million demand had one been made (and Wegman so argued in its brief). To be sure, no $1 million demand was made, and Admiral was not required to make an affirmative offer unless “the probability of an adverse finding on liability [were] considerable and the amount of probable damages would greatly exceed the insured’s coverage.”125 But even that

124 US/IL—629 F.3d at 728.
might have been a plausible possibility under Wegman’s allegations.

If the probability of excess liability required to create the conflict perceived in Wegman were at the level necessary to create a duty to settle, the result would accord with that appropriate under traditional duty-to-settle analysis, coupled with the majority rule that the prospect of excess liability (without any other conflict) frees the policyholder to settle if the carrier has first breached its duty to settle. If Admiral were obliged to make a limits offer (or to tender its limits for settlement), that offer or tender would have provided the notice that the Seventh Circuit concluded was required.

On that basis, even the conclusion that Wegman was entitled to independent counsel was dictum. The supposed right to independent counsel was only significant as a basis for holding that Wegman was entitled to notice. Had Wegman gotten notice, it would have communicated that to its excess carrier and there would have been no need for independent defense counsel. There was no conflict regarding the handling of the trial: Admiral had every incentive to minimize the verdict. And there was no claim that independent defense counsel could have done anything differently that might have improved the result. The only issues were Admiral’s liability for failing to offer or tender its limits or for failure to notify Wegman of the risk of excess exposure.

An analysis based on the duty to settle, rather than on independent counsel would support the result in Wegman in another way. While Illinois courts have not addressed the issue, it is generally agreed by courts and commentators that “[t]he insurer has a duty to provide the insured with certain basic information about settlement opportunities.”128 To be sure, as the district court observed, defense counsel has an independent duty to keep the policyholder informed of developments in the litigation.129 But, if the policyholder is not properly informed, the carrier can be liable for an excess judgment that could have been avoided by providing such information.130 In general, a policyholder should be informed of any settlement demand received from the plaintiff and provided:

sufficient information to make intelligent decisions to protect his own interests … . Furthermore, the insurer must inform the

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126 William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 4.03[2][a].
127 See William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 2.03[6][d][ix].
128 William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 2.03[4][a] (footnote omitted); see Stephen S. Ashley, BAD FAITH ACTIONS: LIABILITY & DAMAGES, §§ 3:09, 3:11 (2d ed. 1997); 1 Allen D. Windt, INSURANCE CLAIMS & DISPUTES, § 5:7 (5th ed. 2007).
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130 Rogers v. Robson, Masters, Ryan, Brumund & Belom, 74 Ill. App. 3d 467, 474 (1979), aff’d on other issues, 81 Ill. 2d 201 (1980).
131 William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION §§ 2.03[4][c]–[d].
insured in a timely manner so that the insured will be able to use the information effectively. If the insured is unaware of the potential adverse liability to him and what steps the insured must take to protect his own interests, the insurer has not carried out its responsibilities to the policy holder.\footnote{132}

This duty to inform could have been triggered by the receipt of the $6 million demand or if it were found that Admiral ought to have offered its $1 million limit (or tendered that limit to Wegman for its use in settlement negotiations).\footnote{133} In either event, timely notice to Wegman would have enabled it to provide earlier notice to AIG. Requesting an excess carrier to contribute to a settlement in excess of primary limits is the sort of conduct the duty to notify is intended to enable. Because it was at least plausible, based on the allegations, that a duty to inform might have been triggered on this basis, dismissal was improper.

A noted commentator has argued that (as the district court appeared to hold) there is no duty to inform the policyholder of excessive demands.\footnote{134} The $6 million demand does appear to be excessive, so that rule might vindicate Admiral’s failure to notify, at least as long as Admiral did not have a duty to offer or tender its policy limit. But, even if an excessive demand would not trigger a duty of notice, there would remain the possibility that Admiral might have been obliged to offer or tender its limits.\footnote{135}

\begin{quote}
[ii] \textit{Wegman Incorrectly Interprets Illinois Law, Especially if Not Narrowly Construed}
\end{quote}

\begin{itemize}
\item [A] In Illinois, the Right to Independent Counsel Is Determined by the Rules of Professional Conduct
\item [I] \textit{Maryland Casualty Co. v. Peppers}
\end{itemize}

As \textit{Wegman} recognized, a carrier with the duty to defend ordinarily has the contractual right to control the defense of the case. Absent an actual conflict of interest precluding joint representation, both carrier and policyholder ordinarily are considered clients of defense counsel in Illinois.\footnote{136} But when there is a conflict of interest regarding the defense, the carrier cannot also

\footnotetext{132}{William T. Barker & Ronald D. Kent, \textit{NEW APPLEMAN INSURANCE BAD FAITH LITIGATION}, SECOND EDITION § 2.03[4][a] (footnotes omitted).}
\footnotetext{133}{See}
\footnotetext{134}{Allen D. Windt, \textit{INSURANCE CLAIMS & DISPUTES}, § 5:7, at 5–45 (5th ed. 2007).}
\footnotetext{135}{See William T. Barker & Ronald D. Kent, \textit{NEW APPLEMAN INSURANCE BAD FAITH LITIGATION}, SECOND EDITION § 2.03[6][d][ix].}
\footnotetext{136}{E.g.,}
be a client of defense counsel unless the policyholder gives informed consent to a conflicted representation.

The leading Illinois case on insurance defense conflicts is *Maryland Casualty Co. v. Peppers*.\(^{137}\) Peppers was sued for both assault and negligent injury. St. Paul had an obligation to defend. This created a conflict of interest regarding the way the suit against Peppers would be defended. Peppers and St. Paul shared an interest in defeating the claim, but their interests diverged if Peppers were to be found liable:

if Peppers is held responsible, it would be to his interest to be found negligent, which, under the policy of insurance, would place the financial loss on St. Paul. On the other hand it would be to St. Paul’s interest to have a determination that Peppers intentionally injured Mims, which, by the terms of the policy, would relieve St. Paul of the obligation to pay the judgment.\(^{138}\)

The Supreme Court held that, as in any other case where there is a conflict between two prospective clients regarding the representation, professional conduct rules “prohibit an attorney from representing both the interests of St. Paul and of Peppers” unless Peppers were willing to waive the conflict or St. Paul were willing to withdraw its reservation of the right to disclaim coverage for intentional injury.\(^{139}\) “Absent the acceptance of the defense by [the policyholder] or the waiver [of its coverage defense] by [the carrier], [the policyholder] has the right to be defended in the personal injury case by an attorney of his own choice who shall have the right to control the conduct of the case.”\(^{140}\) When the policyholder selects independent counsel, the carrier “must reimburse him for the reasonable cost of defending the action.”\(^{141}\)

As *Peppers* holds, the standard for identifying a conflict of interest is the familiar one laid down in the Illinois Rules of Professional Conduct. They preclude representation where “the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.”\(^{142}\)

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\(^{137}\) *Rogers v. Robson, Masters, Ryan, Brumund & Belom, 74 Ill. App. 3d 467, 472 (1979)* (collecting cases), *aff’d, 81 Ill. 2d 201 (1980).*

\(^{138}\) *Maryland Cas. Co. v. Peppers, 64 Ill. 2d 187 (1976).*

\(^{139}\) 64 Ill. 2d at 197.

\(^{140}\) 64 Ill. 2d at 198.

\(^{141}\) 64 Ill. 2d at 198–99.

\(^{142}\) 64 Ill. 2d at 199.
material limitation (as that term is used in the rule) exists “if there is a significant risk that a lawyer’s ability to consider, recommend or carry out an appropriate course of action for the client will be materially limited as a result of the lawyer’s other responsibilities or interests.” In applying this standard to insurance representations, courts have special sensitivity to situations where the choices made by defense counsel could benefit the carrier at the policyholder’s expense.

[II] Application of the Peppers Standard

Neither a coverage question nor the possibility that some portion of the judgment might not be covered creates a conflict of interest if the carrier has no incentive to defend in a way contrary to the policyholder’s interests. A conflict exists only when there is a substantial risk that the way in which the policyholder’s defense is handled could affect the determination of coverage. Note that many coverage questions are unrelated to the matters at issue in the tort action. As the Seventh Circuit held in National Casualty Co. v. Forge Industrial Staffing, Inc., if a vigorous defense of the covered claims will also defend the non-covered claims, there is no conflict. (One panel of the Seventh Circuit cannot overrule another without circulating the opinion to the full court, which does not appear to have been done here.)

Where the non-covered portion of the exposure is purely the amount in excess of limits, the covered and the non-covered claims are the same claims, so a vigorous defense of the covered claims will also defend the non-covered claims. (See § 6.01[4][i] above.)

The Seventh Circuit so held in Littlefield v. McGuffey. Ordinarily, there is no right to

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**II.—ILL. RULES OF PROF’L CONDUCT R. 1.7(a)(2).** This rule is newly adopted since Peppers, but is substantively identical to that in effect at the time of Peppers.

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**II.—ILL. RULES OF PROF’L CONDUCT R. 1.7, cmt. [8].**

144 See Jeffrey E. Thomas & Francis J. Mootz, III, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 16.04[4] (discussing insureds’ rights to independent counsel under the conflict of interest standard and under other standards applied in some jurisdictions).

145 See RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 121, cmt. c(iii) (2000) (general antagonism between clients not conflict, so long as conflicting interests not implicated in particular representation).


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**US/IL—Nat’l Cas. Co. v. Forge Indus. Staffing, Inc., 567 F.3d 871, 876 (7th Cir. 2009) (no right to independent counsel: “In the event that the EEOC charges evolve into lawsuits, both punitive and compensatory damages would be tied to the same underlying conduct, namely Forge’s alleged discrimination against its employees. Thus, in defending Forge’s actions generally, NCC would necessarily be protecting Forge’s interests with respect to both compensatory and punitive damages.”).**

147 Seventh Circuit Rule 40(f).
independent counsel unless “‘the insurer’s and the insured’s interests in the conduct of the tort action are in serious conflict,’” because the carrier and policyholder are “‘complete adversaries on a crucial issue which would necessarily be decided either one way or the other if liability was [sic] imposed.’” Littlefield also recognized that a conflict could exist where the carrier has “‘an interest in providing a less than vigorous defense.’” Neither situation was present in Littlefield. And the Seventh Circuit rejected the argument that excess exposure was sufficient to create a conflict: “State Farm seems to think that the possibility of liability exceeding coverage automatically triggered a conflict of interest. But … the one is not the conceptual equivalent of the other.”

Nandorf, Inc. v. CNA Insurance Cos. supports the same rule. (See § 6.01[4][k] above.)

The only Illinois case finding a right to independent counsel based solely on the existence of excess exposure is Mobil Oil Corp. v. Maryland Casualty Co. Maryland “vexatiously” disputed (for a time) the availability of a $10 million limit, claiming that only $250,000 was available. Mobil was almost certain to be liable for $250,000, which the court felt meant that Maryland’s interests could be “furthered by providing a less than vigorous defense.” (The suggestion is that Maryland might have believed that its limits were effectively gone, so that no defense efforts would provide any benefit to it.) Also, Mobil faced a large non-covered punitive damage exposure and would be in serious danger if the case were allowed to go to trial. For these reasons, the court concluded that Mobil had been entitled to independent counsel. But, while Maryland had the conflicts that commonly accompany excess exposure (aggravated if it thought its limit gone), defense counsel had no such conflict. Mobil Oil is inconsistent with the governing rule laid down by the Illinois Supreme Court in Peppers: existence of a conflict is determined under the Rules of Professional Conduct and with Pekin. Other courts ought not to follow Mobil.

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149 US/IL—Littlefield v. McGuffey, 979 F.2d 101 (7th Cir. 1992). See also Forge Indus. Staffing, 567 F.3d at 878 (“Simply put, if no fact issues appear on the face of the underlying complaint that can be conclusively resolved in such a way that insurance coverage is necessarily precluded under the policy, then appointment of independent counsel is not warranted.”).


152 US/IL—979 F.2d at 108.


155 IL—288 Ill. App. 3d at 756.
Oil on the independent counsel issue.

[B] Wegman Did Not Apply the Peppers Standard

Wegman did not identify any conflict of interest affecting the defense of the case, as would be necessary to trigger a right to independent counsel under Peppers. It identified only a supposed conflict of interest between Admiral and Wegman regarding settlement. Even that conflict would have existed only had there been no excess insurance. Neither Admiral nor defense counsel had any interest in forestalling notice to the excess carrier, though they might well have breached duties to Wegman by failing to notify it.

To say that any conflict affected only Admiral and not defense counsel is not to say there was no remedy. Rather, it is to say that Illinois law provides a different remedy. Illinois law recognizes that, where claims involve a real risk of exposure in excess of limits, “[i]nsurers operate under a conflict of interest; the policy limit drives a wedge between what is good for insurers and what is good for clients.”155 Insofar as this duty relates to the making of settlement offers, it concerns a matter not within the control of defense counsel, who can only make offers that have been authorized by the party who will pay the amount offered. So, the remedy for this type of conflict is not a right to independent counsel: “Most states, of which Illinois is one, require insurers to … make settlement offers within the policy limits[,] as if the insurer bore the full exposure.”156 As the Wegman court itself put the matter, this is a duty “‘not to gamble with the insured’s money by forgoing reasonable opportunities to settle a claim on terms that will protect the insured against an excess judgment.’”157

The Seventh Circuit says that, had Wegman obtained independent counsel, (and had no excess insurance) that counsel could have attempted to make a reasonable settlement that Admiral would have been obliged to pay. Of course, liability insurance policies ordinarily contain provisions restricting the policyholder’s right to settle without the carrier’s consent.158 Wegman’s policy presumably contained such provisions. The Seventh Circuit relies on two Illinois Appellate Court cases.159 Those cases hold that where a carrier has reserved its right to deny coverage and

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US/IL—138 F.3d at 1192 (emphasis added).

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US/IL—R.C. Wegman Constr. Co. v. Admiral Ins. Co., 629 F.3d 724, 725 (7th Cir. 2011), quoting Twin City Fire Ins. Co. v. Country Mut. Ins. Co., 23 F.3d 1175, 1179 (7th Cir. 1994) (emphasis added). A later statement in Wegman suggests either that any gambling with the policyholder’s money would be improper (even though the law permits reasonable gambles) or that the facts here made this gamble improper (something which cannot be determined on the sparse allegations of the complaint).158 William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 2.02[3].

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relinquished control of the defense to independent counsel, that counsel may make a reasonable settlement, which the carrier must reimburse (to the extent of its coverage), despite such restrictions.

In Wegman, Admiral did not reserve its right to deny coverage, and that fact alone distinguishes the cases Wegman relied upon. Moreover, as already explained, Wegman never had any antecedent right to independent counsel, so those cases are inapplicable by their own terms. Finally, even if they were applicable, they follow a minority rule, which has not been adopted by the Illinois Supreme Court. There are strong arguments against that rule. Other courts, if free to do so, ought to reject the rule relied upon in Wegman.

Moreover, the rule assumed by Wegman is even less sound than that adopted by the cases on which it relied. That rule appears to allow the policyholder to settle, without the carrier’s consent, whenever there is some “nontrivial” probability of excess liability, even without some antecedent conflict regarding the defense or breach of the carrier’s duty to settle. That would deprive the carrier of its contractually reserved control over settlement without good cause and contrary to the law virtually everywhere but in the Seventh Circuit.

[11] Punitive Damages Claims May Create a Conflict

In many jurisdictions, punitive damages are uninsurable, and some policies exclude coverage for punitive damages. Even where punitive damages are not covered, a punitive damage claim does not necessarily create a conflict of interest requiring independent counsel. Thus, in Foremost Insurance Co. v. Wilks, the policyholder was sued for allegedly malicious libel, with a claim for punitive damages. Even though the punitive damage claim would not be covered, the


IL—Myoda, 389 Ill. App. 3d at 424 (distinguishing Alliance Syndicate, Inc. v. Parsec, Inc., 318 Ill. App. 3d 590, 600–01 (2000), which had enforced settlement restrictions, on the ground that there was no reservation of rights in Allianced). 161 William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 4.05[1].


court found no conflict. Because Foremost had refrained from reserving its rights under the exclusion for defamatory material published with knowledge of its falsity, it could “gain[] no benefit from pursuing a theory that Wilks acted with malice or reckless disregard for the truth.”\footnote{166}

The only way it could minimize the amount it would have to pay for compensatory damages was to vigorously defend Wilks.\footnote{167}

The Restatement of the Law of Liability Insurance agrees that this conclusion is generally correct:

> When punitive damages are not insured, a demand for punitive damages exposes the insured to a risk that is analogous in some respects to a demand for damages in excess of the applicable limits of coverage. Because the duty to settle does not require the insurer to take the insured’s exposure to an uninsured punitive-damages award into account when making a settlement decision, however, the duty to settle does not address the conflict of interest. Thus, there is potential for the insurer to “gamble with the insured’s money” in those situations in the manner described in [the Section describing the insurer’s duty to make reasonable settlement decisions]. While troubling, this potential should lead to an independent-counsel requirement only if the defense could be conducted in a manner that benefits the insurer at the expense of the insured. The presence of a punitive damages claim does not ordinarily lead to this kind of a conflict of interest. As long as there is no reservation of rights to deny coverage more broadly, there is not the concern about confidentiality of coverage-related information that more typically leads to the need for independent counsel. Moreover, efforts to reduce the insured’s exposure to covered compensatory


\footnote{167}{IL—Illinois Mun. League Risk Mgmt. Ass’n v. Siebert, 223 Ill. App. 3d 864, 875 (1992) (conflict created because finding of malice would preclude coverage even for compensatory damages). Accord:}


\footnote{NY}{Public Serv. Mut. Ins. Co. v. Goldfarb, 53 N.Y.2d 392, 401 (1981) (right to independent counsel as to punitive damage claim, but that claim was based on alleged intentional injuries that created a conflict without regard to the punitive damage claim).}
damages typically also reduce the insured’s exposure to uncovered punitive damages.\textsuperscript{168}

A conflict was found in \textit{Nandorf, Inc. v. CNA Insurance Cos.}\textsuperscript{169} The underlying tort action in \textit{Nandorf} was brought against a store claiming false imprisonment and seeking compensatory damages of $5,000 and punitive damages of $100,000. The carrier affirmed coverage but stated that it would not indemnify for punitive damages because such indemnification would be contrary to public policy. The policyholder’s own counsel then demanded the right to control the defense and to have counsel fees paid by the carrier. During the pendency of the declaratory judgment action, the carrier apparently settled the underlying claim for a small sum, but the issue of liability for the policyholder’s counsel fees remained.

The \textit{Nandorf} court found a conflict of interest because, while both parties shared an interest in defeating liability, their interest diverged on damages. The carrier would be relatively well-served by a minimal compensatory damage award combined with a large punitive damage award. In contrast, the policyholder cared little about the size of the compensatory award but was strongly interested in minimizing any punitive award. In particular, the policyholder would have desired a finding that the employees acted in good faith (even if their conduct was wrongful), thereby barring punitive damages.

However, the \textit{Nandorf} court claimed to be enunciating a narrow rule:

\begin{quote}
Our finding that a conflict of interest existed in the instant case is not meant to imply that an insured is entitled to independent counsel whenever punitive damages are sought in the underlying action. Under the peculiar facts and circumstances of this litigation, punitive damages formed a substantial portion of the potential liability in the [underlying] action and CNA’s disclaimer of liability for punitive damages left Nandorf with the greater interest and risk in the litigation. Notwithstanding the common interest of both insurer and insured in finding total non-liability in the third party action, the remaining interests of the two conflicted to such an extent as to create an actual ethical conflict of interest warranting payment of the insured’s independent counsel by the insurer.\textsuperscript{170}
\end{quote}

This reasoning seems questionable. (See § 6.04[1][b][i] above.) Mere lack of coverage for part, or even all of the claim does not create a conflict. If the fact that the policyholder had the greater exposure were enough to create a conflict, every case with exposure greatly exceeding the policy limits would require independent counsel. But the carrier typically has nothing to gain by


\textsuperscript{169} \textit{Nandorf, Inc. v. CNA Ins. Cos.}, 134 Ill. App. 3d 134 (1985).

\textsuperscript{170} 134 Ill. App. 3d at 140.
magnifying the policyholder’s exposure, even on a non-covered claim: typically, that also tends to increase the likely liability on covered claims.

As one commentator and experienced defense lawyer has explained:

> Although an insurer may be thought to have no interest in defending against punitive damages because they typically are not covered under a standard liability policy, that generally is not so. It remains in the insurer’s best interest to vigorously defend a suit in which punitive damages are sought to avoid liability for compensatory damages. “Aggravating circumstances or conduct giving rise to punitive damages simultaneously increases compensatory damage exposure. An insurer must therefore vigorously defend aggravated litigation in order to reduce its potential indemnity obligation to its insured.” Accordingly, a punitive damage claim, standing alone, does not create a conflict of interest that deprives the insurer of its right to control the defense. 171

Insofar as the fear is that the carrier will not fund a sufficiently vigorous defense, that creates no conflict for defense counsel, who has every incentive to recommend efforts that would earn fees and every incentive to utilize all resources made available. Nor (even apart from the likely inflation of compensatory damages) would that make much sense for the carrier, which would be liable if it caused a less than adequate defense and that resulted in an inflated judgment. (See § 11.03, below.) And the reasonableness of defense expenditures and the causation of any large judgment would likely be questions for a jury unlikely to be sympathetic to a carrier charged with skimping on the defense.

The view that no conflict results from mere diminished incentive to defend claims for which no indemnification will be due is strikingly supported by *Pekin Insurance Co. v. Home Insurance Co.* 172 a case decided a few days after *Nandorf* by a different division of the same court which decided *Nandorf*. In *Pekin*, the policyholder demanded the right to control the defense because the automobile policy’s indemnity limit had already been exhausted by payment on behalf of another policyholder. The carrier declined to pay the policyholder’s chosen counsel and the Illinois Appellate Court upheld its right to refuse payment, despite the argument that a conflict is created by the fact that Pekin is interested in keeping litigation costs to a minimum while the White Sox wish to obtain a full and vigorous defense. The Sox contend that, because of


**US/IL**—*Nat’l Cas. Co. v. Forge Indus. Staffing, Inc.*, 567 F.3d 871, 876 (7th Cir. 2009) (where defense of compensatory damage claims would necessarily protect policyholder against punitive damages, there would be no conflict; also, mere possibility that punitive damages might be sought created no conflict unless and until that occurred).

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this conflict, they not only may choose their own defense attorneys, but also may require Pekin to pay any attorney fees incurred. Illinois, however, has only recognized two situations wherein the conflict of interest would be so great as to require the retention of outside counsel. These situations have involved either conflicts between two parties covered by the same insurer, or circumstances wherein proof of certain facts would move liability from the insurer to the insured. Since the facts here do not fit within either of these exceptions, the Sox cannot maintain their claims under a conflict of interest theory. 173

While the mere existence of a large non-covered exposure should not be considered a conflict, the result in Nandorf was correct. The key to the proper analysis is to focus on the nature of the underlying action there: a claim for false imprisonment by a storekeeper. In such a case, the detention would normally have been rather brief and any compensatory damages would be based almost entirely on emotional distress and would likely depend in significant measure on the jury’s outrage (or lack thereof) at the conduct of the defendant. As such, the separation of compensatory from punitive damages, while sharp in theory, is very indistinct in practice. It is not difficult to imagine that there might be ways of shaping the defense (including the argument to the jury) which might tend to affect the allocation between the two categories of the amount the jury decided to award. 174 While mere existence of non-covered claims does not create a conflict, an opportunity to so conduct the defense as to convert covered liabilities into uncovered liabilities does create a conflict. 175

Some cases do appear to read Nandorf as turning on the combination of a covered small compensatory claim with a much larger non-covered punitive claim, 176 though those factors alone do not appear to create a conflict under the standard laid down in Maryland Casualty Co. v.

173 134 Ill. App. 3d at 35 (citations omitted).
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US/IL—Tews Funeral Home, Inc. v. Ohio Cas. Ins. Co., 832 F.2d 1037 (7th Cir. 1987), arguably gives some support to this view, because it found that determination of whether a conflict was created by the presence of both a punitive damage claim and a covered claim for compensatory damages need not be made at the outset but could be postponed until discovery had revealed the likely nature of the evidence to be presented at trial. This suggests that the problem, if any, does relate to the manner of presenting the case to the jury and not to the development of the case for trial.

175 Accord RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 16, cmt. d (Prop. Final Dr. No. 1 Mar. 28, 2017) (“[I]t is possible that a punitive-damages claim could lead to serious conflict in the defense: for example, if the compensatory damages claimed are so small in relation to the potential punitive damages that the defense of the claim might otherwise be handled in a hard-edged manner that disproportionately risks exacerbating the punitive-damages exposure or if there was a realistic possibility that the manner of presentation at trial could affect the jury’s allocation between pain-and-suffering damages and punitive damages. Accordingly, a bright-line rule is not appropriate. Rather, the question whether an uninsured punitive-damages claim requires independent counsel is determined according to the general rules stated in this Section.”).

176 US/IL—Nat’l Cas. Co. v. Forge Indus. Staffing, Inc., 567 F.3d 871, 876 (7th Cir. 2009) (distinguishing Nandorf on the ground that this combination was not present).
Peppers.177 (See § 6.04[10][d][ii][A] above.)

The Restatement of the Law of Liability Insurance provides an Illustration that suggests another possible basis for concluding that independent counsel would not be required by the presence of a punitive-damages claim:

Insured individual is sued for compensatory and punitive damages arising out of a fatal automobile accident in which the insured allegedly was intoxicated and the plaintiff suffered disabling injuries. The complaint seeks $2,000,000 in compensatory damages and unspecified punitive damages. The punitive damages are not insurable in the jurisdiction. The applicable bodily injury limit of the automobile liability insurance policy is $100,000. The insured does not have other substantial assets that would be available to pay a civil judgment. The insurer agrees to defend, reserving the right to refuse to pay any punitive damages. Because the allegations involving intoxication could also influence the amount of pain-and-suffering damages that a jury awards and because the amount at risk significantly exceeds the policy limits even in the absence of punitive damages, the insurer’s and the insured’s interests are sufficiently aligned that the claim for punitive damages does not create a conflict of interest sufficient to require appointment of an independent counsel.178

Insofar as this suggests that the policyholder’s ability to pay a judgment is a factor in determining the right to independent counsel, that seems unsound. A judgment that the policyholder cannot pay is generally considered injurious on claims for bad faith failure to settle.179 This seems especially true with respect to judgments based on intoxicated driving, which are not dischargeable in bankruptcy.180

[12] Possible Recoupment Claims and Burning Limits Policies

[a] Recoupment

Liability carriers are frequently called upon to defend suits against their policyholders when it is questionable whether there is actually a duty to defend. The consequences of an unjustified refusal to defend can be quite unpleasant, so carriers often defend when they believe there is no duty to do so, but fear that a court might disagree. In such circumstances, they would like to be able to obtain reimbursement (sometimes called recoupment) of the amounts they expend on defense if they later establish that no defense was owed.

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Some jurisdictions allow recoupment in cases where there never was a duty to defend any of the claims asserted against the policyholder;\(^{181}\) some do not.\(^{182}\) Many have not yet taken a position. California, so far uniquely, allows recoupment in cases where there was a duty to defend some of the claims asserted against the policyholder, but not all of the claims (so-called “mixed actions”).\(^{183}\) In such cases, all defense costs which would have been reasonably necessary had only the covered claims been asserted are allocated to those claims; the policyholder’s obligation is only to reimburse those costs which were necessary only to defend the non-covered claims.\(^{184}\)

There is no need here to examine the merits of that debate,\(^ {185}\) as our concern is the implications for defense counsel (and, so, for the right to independent counsel) if a right to recoupment is asserted by the carrier. The potential for conflict is that any defense expenditure increases the possible liability of the policyholder to reimburse that expenditure.

Putting aside defense of mixed actions, there may be no real conflict created by the recoupment claim. Recoupment claims arise only where existence of a duty to defend is uncertain, and if the action is not mixed, it will all be covered or all not covered. If there is no duty to defend, there will be no duty to indemnify.\(^ {186}\) Even if the carrier is relatively confident that this will be the result, it has no incentive to make wasteful defense expenditures merely because it expects the policyholder to have to reimburse them. After all, the policyholder may be unable to pay, suing for payment will be expensive and time consuming, and the policyholder presumably could defend precisely on the ground that the expenditures were wasteful. On the other hand, the risk that coverage might be found gives the carrier an incentive to fund appropriate defense efforts.

Because the policyholder is both potentially responsible for the defense costs and exposed to liability, it will be appropriate to consult the policyholder more closely than usual about defense decisions and it may be particularly useful for the policyholder to have advice from

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\(^ {181}\) E.g.,


\(^ {182}\) E.g.,


\(^ {184}\) CA—16 Cal. 4th at 53.

\(^ {185}\) The merits are examined in William T. Barker & Ronald D. Kent, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 2.11 and Jeffrey E. Thomas & Francis J. Mootz, III, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 16.11.

\(^ {186}\) Jeffrey E. Thomas & Francis J. Mootz, III, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 17.01[2].
personal counsel on such matters. But assigned counsel can advise both carrier and policyholder of case developments, counsel’s evaluations in light of those developments, and the pros and cons of possible approaches to the defense. If they disagree, and if neither will agree to defer to the other, that could create a conflict. (See § 6.01, above.) Unless and until such an impasse develops, assigned counsel can defend the case with undivided loyalty to both policyholder and carrier. 187 If an impasse does develop, the dispute between policyholder and carrier will need to be resolved in collateral proceedings, probably following resolution of the suit against the policyholder.

If recoupment is permitted in mixed actions, there is a further concern that defense counsel might be involved in allocating defense costs between covered and non-covered claims. But counsel has no need to do so in billing the carrier, because the carrier has a duty to pay both types of costs initially, subject to later recoupment from the policyholder. In any recoupment action, defense counsel will be only a witness, testifying to the reasons why counsel thought particular defense activities advisable. The policyholder could offer expert testimony showing that any activities defense counsel thought directed only to non-covered claims were also reasonably necessary to defend the covered claims, and the carrier could offer expert testimony that any activities defense counsel thought useful for covered claims were not, in fact, reasonably necessary to defend those claims. Moreover, as a witness, defense counsel’s only duty is to the truth, not to advancing the interests of either carrier or policyholder.

So, neither the possibility nor the actuality of a recoupment claim should ordinarily create any conflict for defense counsel. 188

[b] Burning Limits Policies

Standard liability insurance policies have a policy limit on the amount payable for judgments or settlements but no limit on the amount payable for defense costs. Some types of specialty policies (e.g., professional liability) are now commonly written with defense costs included (at least to some degree) within the policy limit, and other types of insurance (e.g., commercial general liability) are sometimes written in that form. 189 Such policies are known as

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187 An Arizona case suggests otherwise. Fulton v. Woodford, 26 Ariz. App. 17, 22 (1976) (“Obviously, any insurance company or an attorney employed by an insurance company who undertakes to represent an insured under a reservation of the right to subsequently seek reimbursement from that insured for any losses arising out of that representation has a ‘conflict of interest’ with that insured.”). Because the court found the conflict waived, the conclusion that there was a conflict was dictum.

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189 See Shaun McParland Baldwin, Legal and Ethical Considerations for “Defense Within Limits” Policies, 61 DEF. COUNS. J. 89 (1994); Gregory S. Munro, Defense Within Limits: The Conflicts of “Wasting” or “Cannibalizing” Insurance Policies, 62 MONT. L. REV. 131 (2001). Some states preclude or limit the use of defense within limits policies and the language intended by insurers to have that effect is not always construed that way. Shaun McParland Baldwin, 61 DEF. COUNS. J. at 92–96. For present purposes, it is assumed that provisions for defense within limits are valid and will be construed to have that effect. If invalid or ineffective, this possible source of conflict would be removed. If defense and settlement of multiple actions threatens to exhaust a defense within limits policy, the carrier may suspend its defense payments, interplead the remaining limits, and require further defense costs be sought from the interpleaded funds. Everest Indem. Ins. Co. v. Aventine-Tramonti Homeowners Ass’n, 2012 U.S. Dist. LEXIS 33860, at *1013 (D. Nev. Mar. 14, 2012).
“defense within limits” or, more colloquially, “burning limits” or “wasting” policies. The latter terms reflect the fact that defense expenditures reduce the amount available to pay judgments or settlements. Thus, greater defense efforts can impair the ability of the policy to cover the claim against the policyholder, though they may produce a net benefit if they sufficiently reduce the expected verdict and the settlement value of the claim. This is said to create conflicts for defense counsel, because excessive defense efforts may increase, rather than decrease, the policyholder’s exposure to a judgment in excess of policy limits.190

Defense within limits policies create a special need for both carrier and policyholder to be kept advised of the amount expended on defense costs to date and of the implications of planned defense activities, so each can take account of the implications of that information for possible settlement. The carrier may be obliged to consider making a settlement offer with currently available limits before depleting those limits by planned defense activities.

Just as defense counsel needs to keep both carrier and policyholder advised regarding defense costs, so too, they must be kept advised on liability and damage prospects if the case is tried and the expected utility of planned or proposed defense activities in defeating or minimizing the claim. In particular, this may require more extensive consultations with the policyholder than might normally be required, to give the policyholder an opportunity to object to any defense activities the policyholder regards as unwarranted. Moreover, it may be necessary to advise the policyholder of the possible utility of retaining personal counsel to monitor the defense and any settlement possibilities.

It may also be useful to advise plaintiff’s counsel regarding past and contemplated defense costs, especially those necessary to respond to litigation actions of plaintiff’s counsel. Plaintiff must recognize that any potential recovery may be reduced by further litigation, a fact that may warrant moderation of plaintiff’s settlement demands.

None of these duties should create any conflict for defense counsel, who need merely keep both carrier and policyholder informed and advised. Moreover, if the carrier chooses not to make a settlement offer (or to meet the plaintiff’s demands), defense counsel has little choice but to defend the case in a manner best calculated to reduce the expected judgment and the settlement value. It will rarely be in the policyholder’s interest to suspend the defense. And it is in the interest of both carrier and policyholder to pursue those activities most likely to reduce the plaintiff’s demands at the least cost, relative to the expected reduction.

Of course, defense activities include investigation of the claim as necessary to evaluate it for possible settlement. If the value of the claim may approach or exceed the policy limit, it will be necessary for defense counsel to consider whether the additional information generated by further investigation is likely to be worth the cost of obtaining that information. The carrier and policyholder should be consulted about such decisions.

Nonetheless, while there may be all of the usual tensions and difficulties of other cases with excess exposure (see § 12.05[5] below), aggravated by the special problems of defense within limits policies, those special problems create no conflict regarding the defense. The carrier has no incentive to make wasteful defense expenditures. There may be disagreements between

190 Shaun McParland Baldwin, 61 DEF. COUNS. J. at 98–99; Gregory S. Munro, 62 MONT. L. REV. at 148–49.
carrier and policyholder over defense or settlement strategy, but the problems presented by such disagreements seem no different than those presented by other disagreements. (See § 6.04[13] below.)

If there are multiple defendants subject to a single limit, there will be further problems as defense counsel must balance any desire to keep the limits available for settlement with a desire to get necessary defense activities accomplished while there are still funds available to pay for them. But the carrier ordinarily has no reason to discriminate among policyholders who are entitled to the policy’s benefits, and such problems do not create a conflict unless the carrier does have such a reason. (Those problems will be more complex in cases where the multiple policyholders have inconsistent defenses and separate counsel. (See § 6.04[4] above.) It has been held that an insurer with a burning limits policy may terminate its duty to defend by interpleading the policy limits among the insured defendants and the claimant; claims for further defense costs then compete in the interpleader with claims for damages against the defendants.191

If an excess judgment results and the carrier’s defense expenditures arguably contributed to a failure to settle within limits, the carrier’s management of the defense would be one of the issues in the resulting bad faith action.


To permit identification of conflicts, it is desirable that assigned counsel ascertain whether there is a reservation of rights and, if so, the nature of the coverage issue. Even when there is no conflict and no even arguable right to independent counsel, by reviewing the terms of the engagement a defense lawyer will gain a layer of protection against a malpractice charge. The carrier can be asked to provide any reservation of rights or excess exposure letter to defense counsel. Assigned counsel should make a uniform practice of requesting the policyholder to provide copies of all correspondence from the carrier and of requesting the claim representative to provide any reservation of rights or excess letters sent to the policyholder. Assigned counsel should not request such letters only where a coverage issue is suspected, because that could alert the claim representative to look for a previously unnoticed problem. Alerting the claim representative in that way could (unintentionally) violate counsel’s duty of loyalty to the policyholder.

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Example 5:

Jones was a passenger in a car driven by Stone, and they got into a fight. After they got out of the car, the fight continued, ending when Stone stabbed Jones. Jones sues, alleging intentional and negligent injury. Stone claims that he pulled the knife in self-defense and that he never intended to stab Jones, but only to fend him off. According to Stone, Jones impaled himself on the knife while lunging at Stone. The claim representative assumes the defense but reserves rights to deny coverage on the ground that the injury did not arise out of use of the car and for any intentional injury. The issue about use of the car does not overlap with the issues in the tort case, so it does not create any conflict. But the alternative allegations of intentional and negligent injury create a conflict and a right to independent counsel. When defending the tort claim, the

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carrier might instruct defense counsel to handle the case in ways calculated to make a finding of intentional injury more likely than one of negligence.

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Example 6:
The policyholder’s employee had an auto accident, after leaving work for the day but was carrying a package he intended to drop off at the post office for mailing to a customer. The plaintiff sues both the policyholder and the employee, alleging that the employee was in the course and scope of employment. If so, the employee is covered. There is no problem with assigned counsel representing only the policyholder, regardless of whether the course and scope issue is contested: the policyholder will not be liable unless the employee was in the course and scope and will be covered if liable. The interests of the carrier and the employer are fully consistent. If the course and scope issue is not contested, there is no conflict at all and assigned counsel may represent both employer and employee. If the course and scope issue is contested, the coverage issue for the employee overlaps with the tort action, creating a conflict of interest and entitling the employee to independent counsel.\(^\text{192}\) In addition, the dispute about course and scope may cause the interests of the employer and employee to conflict, preventing a single lawyer from representing both.

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Example 7:
Policyholder has an accident while driving his own car. Plaintiff, whose damages are well within Policyholder’s liability limits, alleges that Policyholder was acting in course and scope of employment, and sues employer as well. Employer demands a defense because the auto policy provides coverage for anyone responsible for the acts of a policyholder. The claim representative agrees to provide a defense, but reserves the right to contend that employer’s own policy is primary. Assigned counsel may defend the policyholder, because the course and scope issue makes no difference to the policyholder. Because neither policyholder nor the carrier have any interest in having the employer held liable, the course and scope issue creates no conflict precluding joint representation. Because the issue of which policy is primary does not overlap with the issues in the tort action, it creates no conflict of interest.

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Example 8:
Driver is using policyholder’s car with permission, and has an accident. Victim sues both, alleging that policyholder negligently maintained the car and driver negligently operated it. Driver and policyholder would have a conflict if there were a substantial risk of liability in excess of policy limits, as each would wish to maximize the other’s responsibility and minimize his own. But, as long as the damages appear clearly within limits, the fact that any settlement or judgment would be covered would ordinarily eliminate any conflict between them and permit assigned counsel to defend both.\(^\text{193}\)

\(^{192}\) See

\(^{193}\) E.g.:
Example 9:

Policyholder is sued on covered grounds, but the complaint alleges damages in excess of the policy limit. The carrier has no interest in increasing the policyholder’s liability beyond limits, so there is no conflict of interest regarding the defense.

Careful attention is required whenever a suit involves two defendants, one of whom is alleged to be responsible for the acts of the other. Vehicle owners are often liable for permissive users. Permissive users may seek to deflect liability onto owners by alleging that the accident resulted from improper maintenance. Commercial landlords and tenants have various divisions of responsibility for maintenance of premises and often have agreements in which one indemnifies and/or promises to insure the other. Each set of facts must be analyzed to determine whether the defendants’ interests conflict and whether either of the defendants has interests in conflict with those of the carrier on any issue involved in the tort case.

Even if the facts initially appear to present no conflict, counsel must be alert to changes that may create conflicts.

Example 10:

Same facts as Example 6. Policyholder initially agrees that employee was in course and scope, so assigned counsel assumed the defense of both. Policyholder later determines that letter employee was supposedly mailing did not exist, and that employee had used it as an excuse to leave the office early. Course and scope is now an issue and conflicts must be reassessed. Once having represented employee, assigned counsel may now be precluded from continuing representation of policyholder, even though counsel could have represented it at outset. It may be necessary to withdraw from representation of both clients.

Example 11:

Same facts as Example 10, but Policyholder only suspects that employee had fabricated the story about the letter. Policyholder asks assigned counsel to investigate this suspicion. Assigned counsel may not do this, because doing so would be disloyal to the interests of the co-client employee. This indication that course and scope may be an issue also requires reassessment of conflicts and new consultations with both policyholder clients about the implications of that issue.

Example 12:

Assigned counsel is defending a professional malpractice claim. Shortly before trial, plaintiff moves to amend the complaint to add claims of fraud and civil conspiracy. If these

US/MS—Davenport v. St. Paul Fire & Marine Ins. Co., 978 F.2d 927, 932 (5th Cir. 1992);

CA—Spindle v. Chubb/Pac. Indem. Grp., 152 Cal. Rptr. 776, 778–81 (Cal. Ct. App. 1979) (same principle holds true even if two insureds are insured by the same carrier under separate policies with different liability limits).
claims are allowed, they will probably create a conflict and require retention of independent counsel, because intentional injuries of those sorts generally will not be covered. But if leave to amend is denied, there will be no conflict.\textsuperscript{194} Assigned counsel should inform the policyholder and may continue to represent the policyholder to oppose leave to amend. The claim representative should be advised to consider steps to select or have the policyholder select independent counsel before the motion is decided, to be ready if the motion is granted.

#Comment Ends

If a reservation of rights creates a conflict that would entitle the policyholder to independent counsel, assigned counsel should so inform the claim representative. Claim representatives sometimes choose to withdraw reservations in order to avoid the expense of independent counsel. If the claim representative chooses to do this, the policyholder benefits by obtaining an assurance of indemnification regardless of the withdrawn coverage defense. But this is an issue where the interests of the policyholder and the carrier can diverge, so assigned counsel should not advise the claim representative whether to withdraw a reservation.

[14] Disagreements Between Carrier and Policyholder Regarding Conduct of the Defense

Even if a lawyer is a tower of strength, independence, and objectivity, a carrier and a policyholder still will disagree over the conduct of the defense occasionally. The carrier may agree with a defense lawyer and the policyholder may dissent. The policyholder may agree with the lawyer and the carrier may dissent. Or, both may disagree with the defense lawyer (and agree or disagree with each other, as the case may be). Do such disagreements create conflicts requiring independent counsel?

The first thing a defense lawyer should realize is that a disagreement over litigation tactics is not the end of the world. Differences of opinion in multiple client representations are as common as grass and usually no more dangerous. When they arise, a lawyer should educate the clients and listen to their views. Usually, the frank recognition and discussion of a disagreement sets in motion a process of refining opinions and reaching a consensus on the course of action to pursue. Defense lawyers can and should play leading roles in this process. Their training and experience enable them to understand many issues better than the clients. They also can be more dispassionate and objective than the clients because they do not stand accused of wrongdoing and their money is not on the line. (This process is discussed in § 12.05\textsuperscript{[4]}, below.)

But what if the disagreement cannot be resolved? If neither carrier nor policyholder is willing to allow counsel to act in accordance with the other’s desires, that will create a conflict, requiring the withdrawal of defense counsel. But that does not entitle the policyholder to independent counsel unless the carrier has acted wrongfully. The carrier has contracted for control. As the Texas Supreme Court has pointed out, that right would be illusory if any disagreement with the policyholder about the handling of the case were deemed to create a conflict entitling the policyholder to take control.\textsuperscript{195} Similarly, the Maryland Court of Special


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Appeals has held that, in a case where the carrier wished to settle and the policyholder wished to litigate:

the parties’ disagreement as to the manner in which Roussos was to be represented does not present the type of conflict of interest that required Allstate to fund an attorney of Roussos’s choosing . . . An insurer’s right to control the litigation against its insured is essential to protect the insurer’s financial interest in the outcome of the suit. We decline to extend an insurer’s duty to provide independent counsel to a situation where the insured merely disagrees with the manner in which he or she is to be defended.196

If the policyholder obstructs the carrier’s exercise of control by objecting to defense counsel following the carrier’s instructions, the policyholder potentially breaches the duty to cooperate and places indemnity coverage in jeopardy.197 The policyholder can instead object to the carrier’s instructions, warn that the carrier will be responsible if they turn out badly, and then allow counsel to follow those instructions.

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US/MS—Davenport v. St. Paul Fire & Marine Ins. Co., 978 F.2d 927, 932 (5th Cir. 1992) (disagreement regarding settlement or defense strategy irrelevant where exposure was fully covered);

NY—Steinman v. Silbowitz, 276 A.D.2d 299, 714 N.Y.S.2d 209, 210 (2000) (disagreements over trial or settlement strategy did not entitle policyholder to independent counsel);


197 MD—Roussos, 104 Md. App. at 91–92.
[15] Conflicts of Interest Resulting from Other Representations Involving the Same Policyholder

[a] Conflicts May Arise from Current or Former Representations

The requirement of independent counsel arises from conflicts involving the same incident as the suit tendered for defense. But other conflicts may be created by prior or current representations involving other matters, requiring the carrier to select some other counsel to represent the policyholder. To avoid such conflicts, all new matters must be checked through an appropriate conflict-checking system.

[b] Current Representation Conflicts

In general, a lawyer representing a client in one matter may not act adversely to that client in another matter, even if totally unrelated. This prohibition is embodied in Model Rule 1.7(a). Accordingly, assigned counsel cannot (without informed consents) defend a policyholder if the firm is currently adverse to that policyholder in any matter, whether in litigation or in a transaction. Nor may the firm take on defense of a new case prosecuted by a current client. Whenever new parties are added in any case, conflicts must be rechecked.

[c] Former Representation Conflicts

Model Rule 1.9 forbids handling a case adverse to a former client of the office, if the new case is “substantially related” to the former representation. The Model Rules adopted this prohibition from case law that primarily protected the interest of former clients in the continued confidentiality of their communications with their former lawyers.

As the Seventh Circuit explained the rule:

For rather obvious reasons a lawyer is prohibited from using confidential information that he has obtained from a client against that client on behalf of another one. But this prohibition has not seemed enough by itself to make clients feel secure about reposing confidences in lawyers, so a further prohibition has evolved: a lawyer may not represent an adversary of his former client if the subject matter of the two representations is “substantially related,” which means: if the lawyer could have obtained confidential information in the first representation that would have been relevant in the second. It is irrelevant whether he actually obtained such information and used it against his former client, or whether—if the lawyer is a firm rather than an individual practitioner—different people in the firm handed the two matters and scrupulously avoided discussing them.199

198 Model Rules of Prof’l Conduct R. 1.7, cmt [6].

TX—In a unique variation, Texas has amended its version of Rule 1.7 to relax this prohibition. Tex. Disc. Rules of Prof’l Conduct R. 1.06 (limiting prohibition to substantially related matters).

This rule protects the former client by avoiding any need to reveal the secrets disclosed to the lawyer in order to prevent the lawyer from using them. To determine whether there is a substantial relationship, one asks “whether it could reasonably be said that during the former representation [the former] attorney might have acquired information related to the subject matter of the subsequent representation.” If so, then the relationship between the two matters is sufficiently close to bring the latter representation within the prohibition. The inference that the lawyer received confidential information relevant to the new representation cannot be rebutted.

There is a presumption that confidential information imparted to one lawyer in a firm has been shared with all lawyers in that firm. But once a lawyer (who was not personally involved in the prior representation) leaves the firm that represents (or formerly represented) a client, that lawyer and the lawyer’s new firm will be permitted to rebut the presumption that the lawyer had access to the client’s information. If they can do so, then neither the lawyer nor the new firm is disqualified from representations substantially related to the one conducted by the lawyer’s former firm.

Some jurisdictions (and the recently amended ABA Model Rules) permit a lawyer disqualified by actual or presumptive exposure to confidential information at a former law firm to be screened from related matters undertaken by the lawyer’s new firm, freeing the other lawyers in the firm from imputation of the new lawyer’s personal disqualification. Unless the local

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202 Restatement Third) of the Law Governing Lawyers § 124, cmt. c(ii) (2000). Leading cases refining this rule include:

US—Silver Chrysler Plymouth, Inc. v. Chrysler Motors Corp., 518 F.2d 751 (2d Cir. 1975); Novo Terapeutisk Laboratorium A/S v. Baxter Travenol Laboratories, Inc., 607 F.2d 186 (7th Cir. 1979); Freeman v. Chicago Musical Instrument Co., 689 F.2d 715 (7th Cir. 1982).

See also

NY—Kassis v. Teacher’s Ins. & Annuity Ass’n, 93 N.Y.2d 611 (1999);


203 Model Rules of Prof’l Conduct R. 1.10.

204 E.g.,

US—Schiessle v. Stephens, 717 F.2d 417 (7th Cir. 1983). The Restatement would allow this only in limited circumstances. Restatement § 124(2) (only where confidential information actually or presumptively received by departing lawyer unlikely to be significant in the subsequent matter).
rules permit this, the scope of a prospective lawyer’s conflicts arising from former affiliations must be carefully considered in making hiring decisions.

#Comment Begins
Example 13:

Assigned Counsel has defended Manufacturer in a series of product defect actions focusing on alleged errors in its manufacturing processes. Manufacturer has now sued Designer alleging that certain machinery was improperly designed, causing defects in products not involved in the prior actions. Despite the differences in products, there is considerable overlap in the manufacturing processes. In addition to asserting that its machines were properly designed, Designer hopes to show that the problems with the product at issue now are largely or primarily the result of aspects of Manufacturer’s processes other than Designer’s machine. **Assigned Counsel will be presumed to have had access, in defending Manufacturer, to confidential information about Manufacturer’s processes that now might be useful in defending Designer against Manufacturer, and this information will be presumed to have been shared among all lawyers in the office. Consequently, Designer’s defense is substantially related to the prior representation of Manufacturer. Assigned Counsel cannot undertake Designer’s defense.**

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Example 14:

Same facts as Example 13, except that Manufacturer was formerly defended by a team headed by Lawyer at Big Firm. Lawyer has now joined assigned counsel’s firm. **Unless the jurisdiction permits imputation to be avoided by screening Lawyer from involvement in the matter, Lawyer’s individual disqualification will be imputed to the entire office. If the jurisdiction does permit screening, the screening mechanism must be in place before the representation of Designer is commenced.**

#Comment Ends

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Example 15:

Same facts as Example 14, except that Lawyer has not joined assigned counsel’s firm. However, Associate has done so, and Associate worked at Big Firm while Manufacturer’s defense was being handled. **If it can be clearly established that Associate had little or no involvement in the matter and no access to confidential information about the sorts of matters relevant to Designer’s defense, neither Associate nor others in the office are precluded from undertaking Designer’s defense.**

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As noted above, changing circumstances may indicate referral to other counsel (possibly independent counsel), even where that did not initially seem appropriate. Assigned counsel should report any developments that might warrant consideration of such referral.

#Comment Begins
Example 16:

Counsel represents a general contractor sued for defective construction. Investigation reveals a basis for seeking indemnity or contribution from a subcontractor. Counsel’s firm has previously represented the subcontractor in a case involving a similar alleged error. Counsel determines that the claim against the subcontractor would be substantially related to the prior representation of the subcontractor. **Because counsel cannot pursue the claim against the subcontractor, that claim will need to be referred to other counsel. Usually, it will be more efficient to refer the entire case to other counsel.**
[16] Differing Interests of Client Constituents

Representation of an organization does not entail representation of any of the organization’s constituents, unless the lawyer allows those constituents to reasonably believe they are clients. In *Landon v. Austin*, Landon sued Austin and Austin Construction, Inc. (“ACI”), a corporation owned by Austin and his wife, for injuries suffered while doing construction work on Austin’s residence. ACI’s insurer provided counsel for it and Austin’s homeowners’ insurer provided counsel for him. Austin was found liable based on a nondelegable duty to comply with certain safety practices, but fact questions remained as to ACI’s liability. Austin feared liability in excess of his homeowners’ policy limit, and sought to defend on the basis that he was acting in his corporate capacity in the events leading to the injury, thereby implicating ACI’s coverage. ACI’s counsel would not cooperate in this, and Austin sought to disqualify them. The trial court rejected this motion and the appellate division affirmed.

The appellate division reasoned that

SKSS has consistently argued that ACI is not liable at all. While this defense could harm the personal financial interests of Austin if it succeeds, SSKS has never represented Austin in his individual capacity. The defense advanced by SSKS clearly furthers the corporate interests of ACI, and the record is devoid of any indication that its actual goal is to recoup funds for the insurer’s benefit from ACI or its principals. In short, because Austin failed to demonstrate the existence of any conflict of interest between ACI and its insurer, Supreme Court did not abuse its discretion in denying his disqualification motion.

The court commented as follows on Austin’s efforts, in his corporate capacity, to direct counsel:

While SKSS has plainly acted in furtherance of ACI’s interests, Austin has attempted to direct SSKS to take a litigation position harmful to a corporation of which he is an owner and officer.

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205 *Model Rules of Prof’l Cond.*, R. 1.13(a); see § 4.04[1][a] (2014).

206 *NY—Landon v. Austin, 129 A.D.3d 1282 (2015).*

207 *NY—Landon v. Austin, 88 A.D.3d 1127 (2011).*

208 *NY—129 A.D.3d 1282, 1282–83.*

209 *NY—129 A.D.3d 1282, 1283–84* (citations omitted).
SSKS properly viewed those efforts with skepticism, as “every one, dealing with an officer of a corporation who assumes to act for it in matters in which the interests of the corporation and officer are adverse, is put upon inquiry as to the authority and good faith of the officer.”

The usual method of dealing with apparent conflicts within an organization is to seek a decision from a higher corporate authority. But in this case, it may be assumed that Austin and his wife controlled the corporation and would have seen the corporation’s interests as congruent with their own personal interests. If defense counsel also represented the insurer (see § 4.04, above), this instruction would have created a conflict, requiring defense counsel to withdraw from the representation if Austin insisted on that course. If the insurer was not a client, following those instructions would have created a coverage issue. But defense counsel ought not to be attempting to decide coverage disputes or attempting to assist either party regarding such disputes. (See § 6.01, above.) Thus, we regard the course taken by defense counsel in Landon as ill-advised. (See also § 12.02, below.)

[17] Differing Preferences on Settlement

Insurers sometimes want to settle when policyholders would prefer not to. (See §§ 9.02[3][E], 12.06, below.) Absent a contractual restriction, the insurer typically has the right to settle, but may not use defense counsel to do so if the policyholder objects. (See § 12.06, below.) Because defense counsel cannot control the insurer’s decision whether to settle, that creates no conflict.

This was the holding in Lynch-Ballard v. LAMMICO Insurance Agency. Lynch-Ballard was a doctor employed by Correct Care, Inc. to work in a hospital emergency room. After Lynch-Ballard left Correct Care’s employ, they and the hospital were sued for malpractice. Over Lynch-Ballard’s objection, the case was settled. Lynch-Ballard sued the insurer and her lawyer.

She argued, inter alia, that the disagreement over settlement created a conflict entitling her to independent counsel. The court found this claim “without merit.”

[18] Litigation Over Liability Arising From Post-Claim Conduct

Valley Forge Insurance Co. v. Hartford Iron & Metal, Inc., concerned an insurer’s right to control defense counsel pursuant to an agreement between the policyholder (“Hartford

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NY—129 A.D.3d 1282, 1283 n.*.
211 MODEL RULES OF PROF’L COND., R. 1.13(b)(3).
212 See WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 2.06[1].
214 LA—176 So. 3d at 653.
215 LA—176 So. 3d at 657.
Iron”) and the insurer (“Valley Forge”). The underlying litigation involved claims by the Indiana Department of Environmental Management (“IDEM”) and the U.S. Environmental Protection Agency (“EPA”) relating to pollution emanating from the policyholder’s scrap yard. Valley Forge provided coverage under a standard liability policy. As the lawsuit proceeded, Hartford Iron and IDEM entered into an Agreed Order to govern the investigation and remediation of the site, and Valley Forge and Hartford Iron separately agreed regarding their responsibilities for complying with the Order.217

Eventually, the relationship between Valley Forge and Hartford soured, and they entered into a second agreement, which contained the following provisions:

(1) Valley Forge may immediately appoint new defense counsel subject to Hartford Iron’s approval, which can’t be unreasonably withheld. The new defense counsel will defend against the EPA and IDEM claims, … , and represent Valley Forge’s interests in prompt and cost effective remediation; … (3) Valley Forge must defend and indemnify Hartford Iron as to the EPA penalty already imposed; (4) Valley Forge must defend and indemnify Hartford Iron with respect to the EPA and IDEM claims, and will “control the defense of these matters”; (5) Hartford Iron must “cooperate with Valley Forge, defense counsel, and [a pollution remediation expert] in implementing the remediation plan; and (6) defense counsel must copy Hartford Iron on all correspondence relating to work at the site.218

The pollution problems worsened, however, and the parties blamed each other. Hartford Iron claimed that Valley Forge’s consultant, August Mack, was mismanaging the remediation, while Valley Forge claimed that the problem was Hartford Iron’s failure to cooperate and to give the consultant necessary access. Valley Forge then sued Hartford Iron for breach of the second agreement. It sought damages for losses it claimed to have occurred because of pollution that stemmed from Hartford Iron’s failure to cooperate with the remediation expert. It also requested a declaratory judgment confirming its entitlement to control the defense of the environmental liability claims. Valley Forge rested this demand on the fact that, in the second agreement, it had conceded coverage for the environmental claims.219

The court concluded that Valley Forge was precluded from controlling the defense.

The court sees this situation as closely analogous to the one in Armstrong Cleaners. In the underlying environmental claims, IDEM and the EPA are alleging—and threatening penalties for—further discharge of contaminated storm water that occurred after August Mack began remediation work. Under Indiana law, a defendant in an environmental action “may assert defenses provided by law or equity, including a defense that damages … were caused in whole or in part by a nonparty.” Not only is this a potential defense available to Hartford Iron, there is

218 148 F. Supp. 3d 746.
219 148 F. Supp. 3d 746–47.
evidence in the record that it has actually been pursued; Ms. Dameron (Hartford Iron’s defense counsel during the initial stages of this case) has sent letters to IDEM encouraging the agency to go after August Mack and Valley Forge for the contamination rather than Hartford Iron, and has testified before this court that the blame-shifting strategy is the only one she believes she can ethically pursue. Hartford Iron’s defense with regard to at least the most recent storm water discharges is essentially that the fault lies not with it but with August Mack’s shoddy remediation work. This is in direct conflict with Valley Forge’s breach claim in this suit, which alleges that Hartford Iron’s bad faith failure to cooperate with August Mack is the cause of the ongoing storm water discharge problem. While IDEM may not make any written findings as to who is to blame, any defense counsel appointed for Hartford Iron but controlled by Valley Forge will need to decide which of the two masters to serve when gathering evidence and preparing reports about the storm water discharges. This conflict is sufficient to materially limit the attorney’s representation of Hartford Iron.

When it comes to the defense of Hartford Iron’s responsibility for pollution that occurred after the second agreement was inked, the court’s analysis makes sense. But one could argue that the second agreement entitled Valley Forge to control the defense of Hartford Iron’s liability on releases that occurred before the agreement was negotiated. If pre-agreement and post-agreement releases could be separated, then Valley Forge’s desire to recoup costs associated with the latter provided no basis for precluding it from controlling the defense of Hartford Iron’s liability for the former, which occurred before the remediation expert chosen by Valley Forge was involved. In practice, it usually would be difficult to divide the defense between two chief counsel, even if the issues were theoretically separable, and courts rarely, if ever impose such a requirement.

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220 148 F. Supp. 3d 751 (citations omitted). Armstrong Cleaners is extensively examined in § 6.04[2], above.