Issues Arising After Breach of the Duty to Defend

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I. INTRODUCTION

The duty to defend is an integral part of most third party liability policies. Prevailing on the question of whether a defense is owed is a primary objective in any third party coverage litigation, and as much time, if not more, may be spent litigating the question of whether the duty to defend exists as is spent litigating indemnification. Attorneys and their clients often view adjudication of the duty to defend as the apex of a case. But once a breach has been found and the dust settles, there are still unanswered questions facing the litigants. While ample case law has developed concerning determination of a breach, there is by comparison precious little consensus regarding the consequences of the breach. This often overlooked territory has given rise to an uncertain legal landscape that can befuddle even the most experienced coverage attorney.

In this article we will examine three such questions that arise in relation to breach of the duty to defend: First, we will discuss circumstances under which the duty to defend may cease such that an insurer may withdraw representation during an ongoing case. Second, we look at the various implementations (or rejections) of the "estoppel doctrine," which holds that an insurer who breaches the duty to defend is estopped from raising coverage defenses. Finally, we review the case law regarding how and when an insurer may challenge the reasonableness of the policyholder's defense fees in the underlying case after the insurer has breached the duty to defend.

II. BACKGROUND

The issues discussed herein are fundamentally issues of compensation and damages. It is well-settled that the damages recoverable for a breach of the duty to defend include the defense costs incurred by the insured. *See* 14 Steven Plitt et al., *Couch on Insurance* § 205:75 (3d ed.) (hereinafter *Couch on Insurance*). What is less well-settled is whether there are any additional repercussions where an insurer breaches the duty to defend. In other words: what is required to adequately compensate an insured after the breach of a duty to defend? If the answer is that more than money damages are required, then how do we fashion a remedy that remains fair to the insurer? In investigating these issues we must begin with a brief examination of the nature of the duty to defend.

In the typical commercial general liability policy, the insurer agrees to defend the insured against any claim for damages resulting from an occurrence or injury that is covered by the policy. *See* Ins. Servs., Inc. Form No.: CG 00 01 04 13 § I(1)(a). At the outset, this agreement presents a Catch-22: the defense of the claim is an immediate need of the insured; however it depends upon a predicate (coverage under the policy) that has not yet been determined. As the Supreme Court of California put it:

> [T]he nature of the obligation to defend is itself necessarily uncertain. . . . The carrier's obligation to indemnify inevitably will not be defined until the adjudication of the very action which it should have defended. Hence, the policy contains its own seeds of uncertainty; the insurer has held out a promise that by its very nature is ambiguous.

Gray v. Zurich Ins. Co., 419 P.2d 168, 173 (Cal. 1966). By the time the underlying action is resolved and the determination of whether the claim is covered can be made, the need for a defense has ceased. The insurer can reimburse the insured for the costs incurred in the defense, but the insured would argue that it has not been compensated for the loss of receiving a defense from the carrier.

In an effort to resolve this problem, the law has developed to hold that the duty to defend is broader than the duty to indemnify and an insurer is obligated to defend any claim that potentially triggers coverage. *See Couch on Insurance* § 200:3. Thus, an insurer may be liable to provide a defense even where the insurer is ultimately found to have no duty to indemnify the insured against the judgment. *Id.* This rule solves the problem of an insured having to wait until the resolution of an underlying action in order to determine if its claim should have been defended; instead, the defense must be provided if there is any potential that the insurer will become liable for the claim.

Inherent in this rule is the recognition that, in purchasing liability insurance, the insured is purchasing more than a right to be reimbursed for monetary losses related to a defense. Instead, the provision of the defense is itself a valuable asset that the insured purchases. This asset has many intangible components. For example:

> In purchasing his insurance the insured would reasonably expect that he would stand a better chance of vindication if supported by the resources and expertise of his insurer than if compelled to handle and finance the presentation of his case. He would, moreover, expect to be able to avoid the time, uncertainty and capital outlay in finding and retaining an attorney of his own.

Gray, 419 P.2d at 168. Not only does an insurer have the resources and expertise to defend a claim and hire a competent attorney, but also most insurance companies have negotiated rates with leading trial counsel throughout the country. Furthermore, by collecting premiums, insurers are able to build a reserve that can be utilized to fund a defense, whereas an insured has paid its premiums in lieu of building such a reserve.

In light of these intangible benefits inherent in the duty to defend, we turn back to the topics at hand: how do courts compensate an insured for an improper denial of a defense? Some courts have determined that economic compensation is sufficient and have not imposed any greater consequences on insurers other than reimbursing an insured for defense costs. Other courts have recognized an intangible benefit in the duty to defend and have fashioned remedies that attempt to compensate in some way for the loss of that benefit. As discussed below, as with the nature of the duty to defend itself, there is uncertainty amongst the courts as to how and when these remedies should be applied.

III. EXTINGUISHING THE DUTY TO DEFEND

Issues regarding remedies for breach of the duty to defend typically arise when an insurer has wrongfully refused to provide a defense. However, there are instances where courts hold that insurers breach their defense duties even after a defense was provided. These situations generally arise in one of two ways: (i) where the insurer defends under a reservation of rights, but subsequently determines that there is no coverage for the underlying claim; and (ii) where the insurer ceases defending after a determination that the policy limits have been exhausted. In either case, the insurer must decide either to cease defending immediately or to seek judicial declaration that its duty to defend has ended. In some instances, an insurer will be permitted simply to cease defending based on its unilateral determination that coverage no longer exists. In other situations, however, an insurer will be held to have breached its duty by failing to file a declaratory judgment action to determine coverage. In order to avoid a breach, an insurer must be able to reliably determine whether its duty to defend has in fact concluded. Unfortunately, the case law has not provided a clear answer to this question. Thus, we begin our discussion of the duty to defend by focusing on when that duty ends: how does an insurer know when its duty to defend has been extinguished?

A. Extinguishing Duty to Defend Based on Coverage Determination

We turn first to the situation in which an insurer defends under a reservation of rights and then stops defending once it determines that there is no coverage for the underlying claim. This typically occurs when part of the underlying claim is dismissed or abandoned by the plaintiff or when factual development of the underlying claim indicates that there is no coverage.

Take for example a case in which an underlying complaint alleged unlawful termination and negligence against the insured. *See Conway Chevrolet Buick, Inc. v. Travelers Indem. Co.*, 136 F.3d 210 (1st Cir. 1998). In *Conway*, Travelers accepted the claim and undertook the defense of its insured, Conway, under a reservation of rights, noting that the negligence claims were potentially covered, but that the unlawful termination claims were excluded. When summary judgment was granted for the defendant on the negligence claims, Travelers withdrew its defense because the remaining termination-related claims were not covered under the policy. Conway then filed a coverage action alleging breach of contract against Travelers. The First Circuit, applying Massachusetts law, held that Travelers was permitted to unilaterally withdraw because the remaining claims in the complaint were not "reasonably susceptible" to an interpretation that fell within coverage, but instead "unambiguously exclude[d] coverage." *Id.* at 214. The *Conway* court reasoned that, if an insurer provided a defense but subsequently learned that the claim was excluded, it should "not be bound to obtain a release" from the court because "no obligation to defend ever existed . . . . "[1] *Id.*

As stated by the California Court of Appeal in a similar case, an insurer is not required to obtain a declaratory judgment before withdrawing a defense where "there *never was* a potential for coverage and, hence, [it] never had a duty to defend from the outset." *Ringler Assocs. Inc. v. Maryland Cas. Co.*, 80 Cal. App. 4th 1165, 1192 (2000).[2] In *Ringler*, the insurer undertook the

[1] It should be noted that, in *Conway*, Travelers conceded that an obligation to defend had existed as to the third party complaint at the time when the negligence claim was pending. It was only as to the unlawful termination claims that Travelers argued there had not been a duty to defend. As such, Travelers was not seeking reimbursement of defense costs that it had incurred during the time that it defended. The question of whether an insurer may recover defense costs expended for a claim that was subsequently determined not to have been covered is another thorny issue that "has been the subject of much debate, and there is a split in authority." *Chiquita Brands Int'l., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, -- N.E.3d --, 2015 WL 9594035, at *9 (Ohio Ct. App. Dec. 30, 2015). A number of courts have permitted reimbursement of defense costs based on the theory that the insurer was not contractually obligated to provide a defense for uncovered claims. *See, e.g.*, *Buss v. Superior Ct.*, 16 Cal. 4th 35 (1997). A minority of jurisdictions, on the other hand, have refused to allow an insurer to recover defense costs absent an express provision in the policy allowing reimbursement. *See, e.g.*, *Gen. Agents Ins. Co. of Am., Inc. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092 (Ill. 2005).

[2] As with *Conway*, there is no indication in the *Ringler* case that the insurer sought reimbursement of defense costs incurred during the time it defended. The language used by the *Conway* and *Ringler* courts is a source of confusion.

defense in an action alleging defamation against the insured. After discovery revealed that all allegations of defamatory statements were excluded under the "prior publication" exclusion, the insurer withdrew from the defense. The court rejected Ringler's argument that a duty to defend existed because of the "potential" that later allegations of defamation could surface. *Id.* at 1176. Instead, the court held that there was no duty to defend "[u]nder the undisputed record." *Id.* at 1187. The court stated that, "[a]lthough it took time for discovery to reveal that there were in fact *no* claims made in this case that were not barred from coverage by the first-publication exclusion, this passage of time did not lock [insurers] into continuing to defend Ringler once that discovery was completed." *Id.* at 1192. Thus, the court held that the insurer had not committed a breach by unilaterally withdrawing. *Id.*

Based on these cases and others like them, it would seem reasonable for an insurer to conclude that its duty to defend generally ceases where "no obligation to defend ever existed" or there "never was a potential for coverage." But this articulation of the rule leads to a fair amount of uncertainty. For example, in *Prichard v. Liberty Mutual Insurance Co.*, 84 Cal. App. 4th 890 (2000), Liberty Mutual defended Prichard in an underlying suit alleging defamation. At the close of evidence in the underlying trial, Liberty Mutual stated that it believed it no longer had a duty to defend, but continued to defend the appeal under a reservation of rights. Liberty Mutual contended that its duty to defend had been extinguished because the "uncontroverted evidence" at trial showed that the defamatory statement had been made before the policy period and thus the claim fell under the "prior publication" exclusion.

By stating that no duty to defend ever existed or that there never was a potential for coverage, the courts seem to be invoking the rule followed by some jurisdictions that an insurer is entitled to reimbursement of defense costs after an adjudication that there never was a duty to defend. And yet, the insurers in *Conway* and *Ringler* do not appear to have sought such reimbursement. It is peculiar and difficult to reconcile why the courts would use this particular language when the issue in *Conway* and *Ringler* was whether the duty to defend had been extinguished and not whether the insurer was entitled to reimbursement.

In light of the rule articulated in *Ringler* and *Conway,* it would seem as though Liberty Mutual's position was correct – that it had no duty to defend once it became clear after the close of evidence that the only allegedly defamatory statements were made before the policy period. Thus, just as in *Ringler*, the "undisputed record" showed that there "*never was* a potential for coverage." *Ringler,* 80 Cal. App. 4th at 1187, 1192. And yet, that is not how the *Prichard* case was decided. The *Prichard* court first attempted to distinguish *Ringler* by stating that Ringler's insurers had acted "mistakenly" by defending in the first place; thus the *Prichard* court conceded that there was no duty to defend at the outset in *Ringler*. *Prichard*, 84 Cal. App. 4th at 902-03. In *Prichard,* on the other hand, the court held that there was a duty to defend at the outset of the underlying case. *Id.* at 901, 903. The court did not elaborate on this point and it is curious given that each case appears to have involved the same material circumstances: (i) allegations that were unclear as to the first publication; and (ii) the eventual development of undisputed evidence showing first publication before the policy period. Regardless, the court held that Liberty Mutual's duty to defend did not cease after the close of evidence, but continued until all appeals had been exhausted. *Id.* at 903-04. The court reasoned that "a new trial might have been granted. Witnesses might have changed their stories or their memories might have improved." *Id.* Luckily for Liberty Mutual, it continued to provide a defense to its insured despite its apparently erroneous determination that the duty to defend had extinguished. Had Liberty Mutual followed the "rule" as articulated in *Ringler,* it may have found itself in breach.

The same confusion arises in attempting to apply the reasoning in *Conway* to similar situations. For example, in *Wells' Dairy, Inc. v. Travelers Indemnity Co. of Ill.*, 336 F. Supp. 2d 906 (N.D. Iowa 2004), Wells brought a breach of contract action against its insurer alleging breach of the duty to defend. Wells had been sued by two customers for breach of contract and negligence. Travelers accepted the defense. However, after summary judgment was granted to Wells on the negligence claim, Travelers attempted to withdraw from the defense on the basis that the breach of contract claim was not covered under the policy. Wells argued that Travelers' duty to defend continued after the summary judgment ruling because the order was an interlocutory ruling that could be appealed. Under the standard set forth in *Conway*, it would seem that Travelers should be entitled to withdraw. Just as in *Conway*, the remaining claims in the underlying complaint "unambiguously exclude[d] coverage." The *Wells* court disagreed. Relying on decisions of the Minnesota Supreme Court and the Hawaii Supreme Court, the *Wells* court held that "an insurer is not relieved of its duty to defend as a result of the granting of a partial summary judgment until no further rights to appeal arguably covered claims exist." *Id.* at 911. Thus, Travelers was obligated to continue providing a defense to Wells in the underlying action despite the fact that no potentially covered claims were currently remaining.[3] *See also Meadowbrook, Inc. v. Tower Ins. Co.*, 559 N.W.2d 411, 417 (Minn. 1997); *Servidone Constr. Corp. v. Security Ins. Co. of Hartford*, 64 N.Y.2d 419, 422 (1985).

These conflicting cases do not give the clearest guidance to an insurer in determining whether its duty to defend has been extinguished. Nor do they allow an insured to make a reliable assessment as to whether its rights have been breached. Some of these inconsistencies may be chalked up to the expected variances between different jurisdictions. But it is also possible that the uncertainty in the case law is a direct result of the uncertain nature of the duty to defend. Where the duty to defend is at the outset measured by the mere potential for coverage,

[3] In both *Prichard* and *Wells* the issues determining coverage had been already determined in the underlying cases, but the court reasoned that the duty to defend continued until all rights to appeal had been exhausted. A different question arises when the issues determining coverage are still being litigated in the underlying case. In those situations, courts generally will not permit an insurer to rely on evidence purportedly undermining the duty to defend where that evidence "tends to determine an issue crucial to the determination of the underlying lawsuit." *Couch on Insurance* § 202:3.

"the question is, how does anyone – the court, the policyholder, the insurer – *know* when the duty ceases." *Prichard*, 84 Cal. App. 4th at 903. The answer may be that there is no one-size-fits all rule. *See id.* Instead, a good rule of thumb for insurers contemplating the withdrawal of a defense may be that articulated by the California Court of Appeal:

> [T]here is no particular requirement that an insurer ask the permission of a trial court before withdrawing from a defense, once the insurer has determined that no potential for indemnification liability exists. However, . . . it may be prudent to do so. Indeed, an insurer that withdraws a defense without first obtaining a judicial declaration that a potential for coverage no longer exists does so at its own risk.[4]

Great Am. Ins. Co. v. Super. Ct., 178 Cal. App. 4th 221, 234 n.19 (2009) (internal citations omitted).

B. <u>Extinguishing Duty to Defend Based on Exhaustion of Policy Limits</u>

The second situation is one in which an insurer provides a defense but ceases defending when it determines that the policy limits have been exhausted. This would seem to be a straightforward analysis: "Where the insurer has exhausted its indemnity limits . . . the insurer *cannot* ultimately be obligated to indemnify the insured. . . . [Thus, when] the insurer has no potential obligation to indemnify it has no duty to defend." *Zurich Ins. Co. v. Raymark Indus., Inc.*, 514 N.E.2d 150, 163 (Ill. 1987). Despite this basic premise, courts have generally not permitted insurers to withdraw from a defense automatically once the policy limits have been tendered, but instead, courts have held that the tender of policy limits does not alleviate the insurer from its defense duties.

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[4] Not all commentators appear to agree with this advice. As one treatise stated:

> Insurance companies should rarely file declaratory judgment actions seeking an adjudication as to whether they have a duty to defend the insured. . . . Moreover, even if the [denial of coverage] proves to have been incorrect, assuming the company acted in good faith and diligently, the adverse consequences to the company are rarely significant enough to warrant the cost of routinely playing it safe by instituting declaratory judgment actions.

2 Allan D. Windt, *Insurance Claims & Disputes* § 8:2 (6th ed.).

This situation is likely to arise in cases where the potential costs of providing a defense are likely to far exceed the limits of the policy. For example, in *Douglas v. Allied American Insurance*, 727 N.E.2d 376 (Ill. App. Ct. 2000), Allied issued an automobile liability policy to the insured with policy limits of $40,000 per accident. The insured was subsequently involved in an automobile accident and was sued by four individuals injured in the accident. Allied accepted the defense but quickly realized that it was in a peculiar situation: defending its insured against four plaintiffs could easily cost more than the $40,000 that it would be obligated to pay even if the insured was held liable. But the insurance policy provided that Allied's obligations to the insured ceased after the policy limits had been expended. Thus, Allied took advantage of what appeared to be a permissible solution. Soon after accepting the defense, Allied deposited the policy limits with the court for disbursement to the underlying plaintiffs. Believing that it had properly fulfilled its obligations under the policy, Allied withdrew its defense.

The Appellate Court of Illinois was not persuaded that this tactic was appropriate, and held that Allied breached the duty to defend by depositing the policy limits with the court. The court looked to the language of the policy, which stated that Allied was obligated to pay "all sums which the insured shall become legally obligated to pay as damages . . . . It is understood and agreed that the company has no obligation to any insured after the applicable limits of the policy have been exhausted by payment." *Id.* at 380. Allied argued that it had no further duties because the policy limits had been "exhausted by payment." The court determined that the phrase "exhausted by payment" was ambiguous and that it must be read in conjunction with the phrase "legally obligated to pay." *Id.* When read together, the court reasoned that the policy limit could be exhausted only by payments made pursuant to a legal obligation of the insured. *Id.* A voluntary payment by the insurer of the policy limits did not qualify as such a payment, and thus, Allied had breached the duty to defend by withdrawing the defense. *Id.* at 380-83. *See also Cty. of Santa Clara v. U.S. Fid. & Guar. Co.*, 868 F. Supp. 274, 278 (N.D. Cal. 1994) (holding that tender of policy limits did not extinguish duty to defend because exhaustion required that "payment must be made to satisfy an obligation arising out of either an adjudication or a compromise of a third party claim"); *but see Carolina Cas. Ins. Co. v. Estate of Studer*, 555 F. Supp. 2d 972 (S.D. Ind. 2008) (holding that filing interpleader action and depositing policy limits with court extinguished insurer's duty to defend where insurer relinquished any claim to the funds and continued to defend pending outcome of interpleader action).

At first glance, the result in *Douglas* appears unfair to an insurer. After all, the insurer attempted to do the right thing by paying the insured the maximum amount owed. However, this holding appears to arise from the argument that the duty to defend is a separate and distinct right from the right to indemnification, and, as such, the mere tender of the funds by the carrier is not enough – it is not what the insured purchased and it does not compensate the insured for its loss. As one court noted:

> [T]he primary insurer cannot extinguish its defense obligation simply by tendering its indemnity limits to the insured and walking away from the fray—a tempting maneuver when it appears that defense costs will exceed indemnity limits. A leading insurance authority explains why courts look askance at this ploy: "Such action invites a change of attorneys and other staff, condemned in other decisions, and can subject the insured to questions as to who will provide him with a defense. It also allows the primary insurer to abandon the insured simply because it finds the costs of handling burdensome and thus escape its responsibility under the policy."

County of Santa Clara, 868 F. Supp. at 277 (quoting Appleman, Insurance Law and Practice, § 4682). Thus, it can be argued that a finding that the insurer does not extinguish its defense duties by simply tendering policy limits prevents the insurer from circumventing the duty that it is contractually bound to provide. This would protect the insured's bargained for right to receive a defense from the carrier, even where the carrier determines that the defense would be a costly one.

Notably, at least one court has recently held that parties cannot contract around the rule enunciated in *Douglas*. In *Doublevision Entertainment, LLC v. Navigators Specialty Insurance Co.*, 2015 WL 5821414 (N.D. Cal. Oct. 6, 2015), the insurance policy stated that the insurer was not obligated to defend after it had deposited the remaining policy limits with a court. In that case, Navigators had issued an errors and omissions policy to Commercial Escrow Services ("CES") and its principal Antoinette Hardstone. The policy had a limit of $1 million, which was depleted by the defense costs paid. Beginning in 2010, CES and Hardstone were sued by a number of customers alleging improper escrow handling. After CES and Hardstone tendered to Navigators, Navigators assumed the defense of the claims.

While the claims were pending, the California Department of Corporations conducted an investigation into CES and determined that there was a shortage of $195,750 in CES' escrow accounts. The Department of Corporations appointed a receiver to liquidate CES' business. The receiver also had authority to collect any insurance proceeds due to CES in order to cover the $195,750 shortage.

The underlying claims against CES and Hardstone remained pending into 2012, at which time Navigators offered to tender the remaining policy limits directly to CES and Hardstone. However, the Department of Corporations notified Navigators that the CES shortage had not been satisfied and thus, the Department had a claim against any policy proceeds in the amount of $195,750. In light of the fact that there were two entities claiming the policy proceeds – the insured and the Department of Corporations, Navigators filed a complaint for interpleader and deposited the $466,358 remaining policy limits with the court. Navigators then ceased defending CES and Hardstone in the ongoing cases. Left with no money to fund their defense, CES and

Hardstone were forced to hire inexperienced substitute counsel on short notice and ultimately had judgments of over $1.5 million awarded against them. One such verdict was obtained by Doublevision, who took an assignment of CES and Hardstone's rights against Navigators as partial satisfaction of the judgment.

Doublevision then instituted a coverage action against Navigators, alleging that Navigators had breached its duty to defend by interpleading the entirety of the policy limits rather than only the $195,750 over which there were competing claims by the insured and the Department of Corporations. In response, Navigators argued that the policy explicitly permitted it to cease defending the insured once it had "deposited the remaining available limit of liability into a court of competent jurisdiction." *Id.* at *1, 4.The court rejected Navigators' argument. Relying on the "supreme importance of the duty to defend," the court held that "the insurance policy in question should be read as erasing the duty to defend only to the actual extent that conflicting claims [on the policy proceeds] are pending." *Id.* at *4. The court stated that Navigators could not simply interplead the funds and abandon its insured "at the moment of her greatest peril. . . . Navigators simply had no right under the contract to cut off the supply of oxygen to the defense . . . ." *Id.* at *1, 5. Thus, the court held that Navigators had breached the duty to defend by withdrawing its defense after interpleading the policy limits, even though the policy expressly allowed such an action. The court noted that Navigators may have been permitted to interplead only the $195,750 over which the Department of Corporations and the insured had conflicting claims, but it could not interplead the entirety of the remaining limits. The court stated that it based its ruling on the "fundamental principle . . . [of] the supreme importance of the duty to defend . . . ." *Id.* at *4. This ruling instructs that an insurer may not unilaterally extinguish its duty to defend by tendering policy limits – even if the policy appears to explicitly authorize such a maneuver. Instead, this holding prioritizes the "supreme importance" of the provision of the defense itself and imposes a consequence protecting the non-economic aspects of that right.

The *Doublevision* opinion appears to advocate a public policy prohibition against a allowing the withdrawal of a defense upon the interpleading of policy limits. Curiously, unlike the other cases discussed in this section, the policy in *Doublevision* was a "wasting limits" policy under which the policy limits were reduced by the costs spent on the defense. This means that, if Navigators spent $1 million on the defense, it could have sought to withdraw at that time and would not have been liable for any additional indemnification on the underlying judgments. This is unlike a defense outside limits policy, where the insurer would be bound to provide a defense regardless of the cost and still indemnify the judgment or settlement up to the policy limits. In this latter situation, allowing a provision like the one in the *Doublevision* policy would collapse the duty to defend into the indemnity limits of the policy, thus, in effect, placing a limit on the duty to defend that was not explicitly stated in the policy. This could be viewed as deceptive practices because it invites the insurer to abandon the obligation that it made to defend outside of policy limits.

IV. DISPUTING COVERAGE AFTER A BREACH OF THE DUTY TO DEFEND

The next question we examine is whether an insurer may contest that a claim is covered by a policy once the insurer has been found to have breached the duty to defend. With the duty to defend adjudicated, the parties turn to the question of whether the insurance company is liable to indemnify the insured for amounts paid as a result of a judgment or settlement in the underlying action. The broad standard for determining the duty to defend, *i.e.*, any potential for coverage, no longer applies. Instead, an insurer generally is liable to indemnify the insured only if the judgment or settlement is in fact covered by the policy. Thus, one would think that the litigation would proceed normally after the adjudication of the duty to defend, with the insurer arguing that the judgment or settlement is not covered on the actual facts and the insurer has no obligation to indemnify the insured.

And yet, some courts have held that, as a consequence of the breach of the defense duty, the insurer may not assert coverage defenses. This rule is often referred to as a "forfeiture rule" or an "estoppel doctrine" based on the premise that the insurer's breach acts to forfeit or estop it from asserting coverage defenses. This rule is the subject of much criticism and has been rejected in the majority of jurisdictions. But, as discussed herein, many argue that to abandon this rule outright may be ignoring the uncertain and intangible nature of the duty to defend.

This section shall discuss the implications and justifications of the three approaches generally taken by courts in this situation: (i) rejection of the estoppel doctrine, stating that an insurer can raise coverage defenses regardless of a breach; (ii) the automatic estoppel rule, stating that a carrier is automatically estopped from contesting coverage by breaching; and (iii) the limited estoppel doctrine, stating that a carrier is estopped from raising coverage defenses only if the breach was wrongful or unreasonable.

A. Rejection of the Estoppel Doctrine

The majority of jurisdictions have rejected the estoppel doctrine and held that an insurer may raise coverage defenses even after the breach of the duty to defend.[5] In so holding, most

[5] *See, e.g., Ala. Hosp. Ass'n Trust v. Mut. Assur. Soc. of Ala.*, 538 So. 2d 1209 (Ala. 1989); *Sentinel Ins. Co. v. First Ins. Co. of Haw.*, 875 P.2d 894 (Haw. 1994); *Hirst v. St. Paul Fire & Marine Ins. Co*., 683 P.2d 440, 447 (Idaho Ct. App. 1984); *Lee Builders, Inc. v. Farm Bureau Mut. Ins. Co.*, 104 P.3d 997 (Kan. Ct. App. 2005); *Arceneaux v. Amstar Corp.*, 66 So. 3d 438 (La. 2005); *Elliott v. Hanover Ins. Co*., 711 A.2d 1310 (Me. 1998); *Mesmer v. Md. Auto. Ins. Fund*, 725 A.2d 1053 (Md. 1999); *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 922 (Mass. 1993); *Kirschner v. Process Design Assocs., Inc.*, 592 N.W. 2d 707 (Mich. 1999); *Shannon v. Great Am. Ins. Co.*, 276 N.W.2d 77 (Minn. 1979); *Ross v. Home Ins. Co.*, 773 A.2d 654 (N.H. 2001); *Med. Protective Co. v. Fragatos*, 940 N.E.2d 1011 (Ohio Ct. App. 2010); *Nw. Pump & Equip. Co. v. Am. States Ins. Co.*, 925 P.2d 1241 (Or. Ct. App. 1996); *Am. States Ins. Co. v. State Auto Ins. Co.*, 721 A.2d 56 (Pa. Super. Ct. 1998); *Utica Nat'l Ins. Co. v. Am. Indem. Co.*, 141 S.W.3d 198 (Tex. 2004); *Potesta v. U.S. Fid. & Guar. Co.*, 504 S.E.2d 135 (W. Va. 1998).

courts cite to the basic tenets of contract interpretation and damages law, with some appeal to equitable principles. The most common rationales supporting the rejection of the estoppel doctrine can be broken down into four arguments, each discussed in turn.[6]

First, courts rejecting estoppel find that prohibiting coverage defenses goes beyond the permissible damages that should be awarded as a result of a breach. "When a contract is breached, the injured party is entitled to receive what would have been obtained if there had been no breach; the injured party is not entitled to receive more." 1 Windt, *Insurance Claims and Disputes*, §4:37. Under this rubric, the "proper measure of damages for breach of a contractual duty, including an insurer's duty to defend, is contract damages." *Deluna v. State Farm Fire & Cas. Co.*, 233 P.3d 12, 17 (Idaho 2008). Such damages are simply the costs incurred in providing one's own defense. *Id.* Unless specifically pled and proven, no further repercussions follow from the breach, and according to these jurisdictions, any other result would be improper.[7] *Id.* As one insurance scholar noted, if the insurer had defended and there had been no breach, then at the end of the day the insured still would be liable for a judgment based on a non-covered claim. The fact of the breach should not relieve the insured of the costs of a

[6] Most criticism of the estoppel doctrine is based on a fundamental disagreement with its justifications. However, at least one commentator has argued that the existence of the rule itself was simply a mistake. *See* Todd J. Weiss, *A Natural Law Approach to Remedies for the Liability Insurer's Breach of Duty to Defend: Is Estoppel of Coverage Defenses Just?*, 57 Alb. L. Rev. 145, 149-54 (1993) (arguing that the case establishing the "modern estoppel rule" involved a "misunderstanding and misapplication of earlier cases").

[7] These jurisdictions appear to leave open the possibility that an insured may recover the amount of a judgment or settlement regardless of coverage if he can show that the liability arose as a consequence of the breach of the duty to defend. *See Sentinel Ins. Co.*, 875 P.2d at 913 ("Certainly, in individual cases, the application of waiver or estoppel will be appropriate – for example, where the insured has been prejudiced in some way by the insurer's failure to provide a defense or where the insurer has taken inconsistent positions with regard to defense and coverage.") (citations omitted); *Deluna*, 233 P.3d at 17 (stating that damages for breach of the duty to defend are "attorney fees and costs for defending the claim, together with any other damages shown to be a result of the breach"); *see also* 1 Windt, *Insurance Claims and Disputes*, §4:37 ("It is less than logical, therefore, to hold insurers that have breached their duty to defend automatically liable for all judgments and settlements simply because, in certain highly unusual circumstances, it is possible that the insurer's actions may have contributed to the entry or amount of a judgment or settlement. The better rule, and the one followed by most courts, is to award such consequential damages only when they can be proved by the insured.").

judgment that "would have been his responsibility regardless." Appleman, *Insurance Law and Practice*, § 4689, n.13.

Second, courts often reject the estoppel doctrine on the basis that it improperly conflates the separate and distinct duties of defense and indemnity. In *Servidone Construction Corp.*, the New York Court of Appeals emphasized that the obligation to defend is "measured against the allegations of pleadings," but the duty to indemnify is "determined by the actual basis for the insured's liability to a third person." 64 N.Y.2d at 424 (citation omitted). The court held that the lower court erred by imposing indemnity liability based on a finding that there had been a duty to defend because it had "in effect applied the same standard" to both the duty to defend and the duty to indemnify. *Id.* In doing so, the lower court ignored the fact that the duty to indemnify is "distinctly different" from the duty to defend. *Id.* Thus, an estoppel rule is improper because it "subverts any meaningful distinction between the duty to defend and the separate duty to indemnify . . . ." *Sentinel Ins. Co.*, 875 P.2d at 912.[8]

The third rationale supplied by courts rejecting estoppel is that preventing the insurer from raising coverage defenses would violate basic contract interpretation principles. It is well settled that, when interpreting an insurance policy, the policy language "must be accorded its natural and ordinary meaning, and courts cannot indulge in forced construction ignoring provisions or so distorting them as to accord a meaning other than that evidently intended by the parties." *Couch on Insurance* § 22:9. Thus, estoppel-rejecting jurisdictions argue that imposing

[8] In *Sentinel*, the Supreme Court of Hawaii rejected the estoppel doctrine, but it did impose some repercussion as a result of a breach of the duty to defend. The court stated that "fairness to both parties requires that the equities be balanced in each case" and held that a breach of the duty to defend results in a rebuttable presumption that the claim is covered, with the insurer bearing the burden of proof to negate coverage. 875 P.2d at 914; *see also Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 922 (Mass. 1993). While the Hawaii Court may have been attempting to concede some victory to the insured, the result is cold comfort at best. This ruling merely relieves the insured of the obligation to show that the claim falls within the scope of coverage; however, given that the claim was already found to potentially be covered such that there was a duty to defend, this burden would in the vast majority of cases already be satisfied.

liability where none exists under the terms of the policy would "enlarge the bargained-for coverage . . . ." *Servidone Constr. Corp.*, 477 N.E.2d at 424. The insured would in fact obtain a "windfall" by receiving a "benefit it did not bargain for." *Sentinel Ins. Co.*, 875 P.2d at 912. As one scholar colorfully put it:

> A breach of contract . . . does not nor should it create a new contract. To say that because the insurer breached the contract he cannot rely on a policy exclusion pertaining to coverage is the same as to say that because the wholesaler refused to sell hamburger as he had agreed he can be forced to sell steaks instead at the same price.

Appleman, *Insurance Law and Practice*, § 4689, n.13.

The final rationale commonly cited by courts is that precluding coverage defenses is improperly punitive. The general rule in compensating for breach of contract is to make the plaintiff whole, "not to punish the breaching party." *Hirst*, 683 P.2d at 447. Prohibiting an insurer from raising coverage defenses as a result of the breach does not compensate the insured, but "serves no more than to punish the insurer for the breach of a contractual duty." *Sentinel Ins. Co.*, 875 P.2d at 912; *see also Servidone Constr. Corp.*, 477 N.E.2d at 424; *Hirst*, 683 P.2d at 447 ("We question the propriety of utilizing a form of estoppel as a punitive measure against an insurer for breach of a contractual duty to defend."). These courts have rejected the argument that estoppel acts as a deterrent to prevent insurers from disavowing their duty to defend. This deterrent, these courts argue, already exists in that, by refusing to defend, an insurer loses the right to control defense costs and strategy, which ultimately exposes it to higher payments as a result of the breach of the duty to defend than it would have incurred had it defended in the first place. *Sentinel Ins. Co.*, 875 P.2d at 913. In addition, an insurer may be liable for tort damages if its breach was in bad faith. Such "[r]esort to tort concepts where fitting, rather than the regulatory estoppel penalty, preserves the traditional distinction between tort and contract remedies." *Id.* Further, these courts note that, where the underlying case involved the adjudication of facts determinative of coverage, the insurer will be collaterally estopped from re-litigating those facts in a subsequent coverage action.[9] *Id.* Thus, the estoppel doctrine is not needed to protect an insured from re-litigating already decided facts. In the absence of any other reasonable justification for estoppel, these courts hold that the rule's only purpose is punitive. As such, they contend that estoppel cannot be used as a contractual remedy.

B. Automatic Estoppel Rule

Despite these arguments, many courts continue to apply the automatic estoppel rule, holding that a breach of the duty to defend precludes any coverage defenses and automatically imposes liability on the insurer for any judgment or settlement.[10] There are three main justifications for this rule: (i) breach of the policy as to the duty to defend equitably estops the insurer from asserting coverage defenses; (ii) estoppel is a needed remedy in jurisdictions with little or no bad faith liability; (iii) estoppel deters insurance companies from breaching their duties and protects the intangible benefits inherent in the duty to defend.

The most common explanation for the estoppel doctrine is that it is an equitable remedy needed to protect an intangible asset. As discussed above, the nature of the duty to defend is a unique one in that it is inherently uncertain. When purchasing coverage containing a duty to defend, the insured purchases more than just the right to an economic benefit. The policyholder purchases the right to obtain a service, which brings with it a number of intangible benefits. For one, the policyholder purchases the ability to take advantage of the insurer's resources and

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[9] While the breaching insurer would not have been a party to the underlying action, it would have been "given the opportunity to appear on behalf of the insured [and] . . . will be bound by that judgment." *Farmers Ins. Co. of Ariz. v. Vagnozzi*, 675 P.2d 703, 706 (Ariz. 1983).

[10] *See, e.g., Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co.*, 230 A.2d 21 (Conn. 1967); *Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122 (Ill. 1999); *Am. Gen. Fire & Cas. Co. v. Progressive Cas. Co.*, 799 P.2d 1113 (N.M. 1990); *Pulte Home Corp. v. Am. S. Ins. Co.*, 647 S.E.2d 614 (N.C. Ct. App. 2007); *Farmers Union Mut. Ins. Co. v. Staples*, 90 P.3d 381 (Mont. 2004); *Se. Wis. Prof'l Baseball Park Dist. v. Mitsubishi Heavy Indus. Am., Inc.*, 738 N.W.2d 87 (Wis. Ct. App. 2007).

experience in defending a claim. In addition, the insurance provides peace of mind to the insured that it will have access to a robust defense in case of a lawsuit. Further, because it purchases the insurance and pays the premiums, the policyholder foregoes setting aside any funds in case of a lawsuit – that is precisely the purpose of the insurance. The insurer on the other hand is able to build a reserve through the collection of those premiums such that it is prepared to litigate in the case of a claim. For these reasons, from the insured's perspective, the recovery of defense costs may not adequately compensate for the loss of the intangible benefits derived from an insurer's defense.

Courts applying the estoppel doctrine adopt these arguments and hold that monetary damages alone are not adequate. Ordinarily in such a situation, a court might apply the equitable remedies of rescission or specific performance. It is well-settled that "[w]here damages are an inadequate remedy and the nature of the contract is such that specific enforcement of it will not be impossible or involve too great practical difficulties, such as long, drawn out and extensive supervision, equity will grant a decree of specific performance." Williston on Contracts § 67:1. A breach of the duty to defend is just such a situation – damages are inadequate and specific performance in most instances is impossible because the underlying case will have concluded. Similarly, rescission would merely return premiums to the insured, but would not remedy the lack of defense. Faced with a situation where typical equitable remedies are not available courts have invented a creative solution in the form of estoppel or forfeiture. The insurer, "after breaking the contract by its unqualified refusal to defend, should not thereafter be permitted to seek the protection of that contract in avoidance of its indemnity provisions." *Missionaries of the Co. of Mary, Inc.*, 230 A.2d at 26. To put it another way, "an insurer's duty to defend under a liability insurance policy is so fundamental an obligation that a breach of that duty constitutes a repudiation of the contract." *Employers Ins. of Wausau*, 708 N.E.2d at 1135.

The second justification for estoppel is that it is a necessary remedy in jurisdictions that limit bad faith damages. The anti-estoppel courts have argued that estoppel is not a necessary remedy because the insured can recover additional damages under tort law. However, this argument is undermined in a state where the damages available as a result of an insurance company's bad faith are strictly limited by statute. For example, in Illinois, an insured's bad faith damages are capped at either a percentage of the overall recovery, $60,000, or the excess amount of a settlement offer over the amount actually recovered. *See* 215 ILCS 5/155. In a case where an insured's defense costs are substantially less than the ultimate judgment against it, this bad faith remedy will fall far short of fully compensating the insured. This is likely an explanation for why Illinois was an early and ardent adopter of the estoppel doctrine.

Limited bad faith remedies are also a factor in the third justification for the estoppel doctrine, which is that the rule deters insurance companies from breaching the duty to defend. If there are minimal repercussions as a result of bad faith, then an insurer does not risk much by unreasonably refusing to defend. For example, in Illinois, if an insured faces a consequence only a $60,000 penalty in addition to defense costs, it may view a breach as the more "efficient" option. After all, not every insured will pursue a coverage lawsuit, so there may be no risk at all in breaching. In addition, potential punitive damages will act as a deterrent only if the insurer has no reasonable basis to deny a defense. If the insurer has a reasonable basis to believe that the claim does not raise a potential for coverage, then a denial would generally not expose the insurer to bad faith liability. In such a case, potential tort liability is no deterrent at all. Thus, in a non-estoppel jurisdiction, if there is any question as to whether a duty to defend exists, then the insurer has less of an incentive to provide a defense. Denying the defense and later being held to have breached subjects the insurer to the exact same exposure that it had at the outset – paying the defense fees. And as an added benefit, the insurer has had use of the funds in the interim. Courts in estoppel jurisdictions have concluded that such a result disregards the benefit purchased by the insured. It renders the duty to defend nothing more than a duty to reimburse defense costs – and yet, these are distinctly different contractual obligations, as recognized by the fact that insurers charge different premiums for each type of coverage. By imposing an equitable remedy for the breach of the duty to defend, courts applying the estoppel doctrine have found that a further remedy is needed to make breaching more costly and to protect the intangible benefits of the duty to defend.

In addition to these three main justifications, courts applying estoppel have rejected the argument that an insured is protected because it may recover the amount of a judgment or settlement as consequential damages. As noted above, some courts have suggested that the estoppel doctrine is not necessary because where the conduct of the insurer in refusing a defense prejudiced the insured, the insured is able to seek the amount of the judgment as consequential damages. *See Sentinel Ins. Co*., 875 P.2d at 913; *Deluna*, 233 P.3d at 17. However, in order to obtain such a ruling, an insured would have to prove that the failure of the carrier to provide a defense was the direct cause of the judgment. Perhaps an insured could meet this burden in a case where it could not afford underlying counsel and a default judgement was entered or the counsel retained was woefully inadequate. Apart from such an extreme circumstance, it is difficult to ascertain how such a showing could be made. The insurer should not be "permitted, by its breach of the contract, to cast upon the plaintiff the difficult burden of proving a causal relation between the defendant's breach of the duty to defend and the results which are claimed to have flowed from it." *Missionaries of the Co. of Mary, Inc.*, 230 A.2d at 26. Thus, it may be argued that the insured's potential ability to seek recovery of a judgment as consequential damages of the breach is a minimal protection at best.

It should be noted that, even within jurisdictions that adopt the automatic estoppel rule, it is not without its limits. For example, the Supreme Court of Connecticut has recently narrowed its application of the estoppel doctrine. In *Capstone Building Corp. v. American Motorists Insurance Co*., 67 A.3d 961 (Conn. 2013), the court reaffirmed its earlier holding that a breaching insurer may not raise coverage defenses. However, it created what could be argued is a rather large exception. The court held that, where the insured settled all claims in the underlying litigation, the breaching insurer was liable for only the settlement amounts proportionate to the potentially covered claims. The court reasoned that "holding an insurer liable for the settlement of claims which it had no duty to defend is per se unreasonable . . . ." *Id.* at 999. It is not clear how this ruling can be reconciled with the automatic estoppel rule, and it does not appear that Connecticut courts have thus far had occasion to try. If it is unreasonable to hold a breaching insurer liable for amounts paid to settle claims for which it had no duty to defend, then how can it be held liable for amounts awarded as a judgment for claims for which it had no duty to defend. The court did not provide much guidance in this regard, and it remains to be seen if courts will use the *Capstone* holding as a means to further erode the protections to insureds provided by the estoppel doctrine.

A second limitation that has been placed on estoppel is an exception for late notice defenses. For example, in *Pulte Home Corp. v. American S. Ins. Co.*, 647 S.E.2d 614 (N.C. Ct. App. 2007), the insurer argued first that there was no duty to defend because the underlying claim did not fall within the scope of coverage and second, that even if there was a duty to defend, it was not liable for defense and indemnity costs because the insured provided late notice of the claim. The Court of Appeals of North Carolina began by stating that it was "well established in North Carolina that when an insurer without justification refuses to defend its insured, the insurer is estopped from denying coverage and is obligated to pay the amount of any reasonable settlement . . . ." *Id.* at 617 (quotations omitted). The court then held that the third party claim did fall within the scope of the policy and that American Surety did have a duty to defend Pulte. *Id.* at 620. One would think that, under the estoppel doctrine, this would end the inquiry – as a result of the breach, American Surety would be liable for the defense costs and the underlying settlement. However, the court allowed American Surety to raise the coverage defense that Pulte's late notice of the claim defeated any claims under the policy. While American Surety was ultimately unsuccessful based on the facts of the case, the court's allowance of the insurer to argue that its breach was "justified" would seem to undermine the estoppel doctrine.

In fact, courts in other jurisdictions facing the same question have unequivocally held that the estoppel doctrine prohibits all defenses, even that of late notice. In *Employers Insurance of Wausau,* the Supreme Court of Illinois rejected the insurer's argument that it could still raise the defense of late notice after it had breached the duty to defend. The insurer, relying on earlier Illinois appellate court decisions, argued that the notice provision in the policy was a condition precedent to coverage. Thus, it argued, because that condition had not been fulfilled, the duty to defend was never triggered and the estoppel rule could not apply. The court refused to adopt this rule and overruled the appellate cases that had done so. *Emp'rs Ins. of Wausau,* 708 N.E.2d at 1136. The court reasoned that when an insurer believes that late notice negates its obligations under the policy, the proper recourse is to defend under a reservation of rights and bring a declaratory judgment action. *Id.* To hold otherwise would allow the insurer to "abandon its insured" and would "seriously undermine the effectiveness of the estoppel doctrine and its intended enforcement of the duty to defend." *Id.*[11]

Finally, even where a jurisdiction appears to have unequivocally adopted the estoppel doctrine, it may not be universally applied. In *Conanicut Marine Services, Inc. v. Insurance Co. of North America*, 511 A.2d 967 (R.I. 1986), the Supreme Court of Rhode Island held that "where an insurer refuses to defend an insured pursuant to a general-liability policy, the insurer will be obligated to pay, in addition to the costs of defense and attorneys' fees, the award of damages or settlement assessed against the insured." *Id.* at 971. This would seem to be an unequivocal adoption of the estoppel doctrine by the Supreme Court of Rhode Island. However, when a federal district court in Rhode Island considered the estoppel question in 2007, it held that the estoppel doctrine did not apply. *Emhart Indus., Inc. v. Home Ins. Co.*, 515 F. Supp. 2d 228 (D.R.I. 2007).

In *Emhart*, the court acknowledged the holding in *Conanicut*, but noted that the "mechanical application of *Conanicut* to these facts would impose an astronomical penalty on Century. . . . Considering the fact that the jury has already absolved Century of any indemnity obligation, this penalty would be more than unreasonable – it would be completely irrational." *Emhart Indus., Inc.*, 515 F. Supp. 2d at 260. The court noted that a Rhode Island state court may be "inclined" to follow the rule enunciated in *Conanicut*; however, "a federal judge is not a ventriloquist dummy; . . . a federal court may, in a sense, 'overrule' an outmoded decision by predicting that the state's highest court would, if presented with the opportunity, do the same." *Id.* at 260-61 (citations omitted).

[11] Illinois does recognize a "narrow exception to the estoppel doctrine . . . where there is a serious conflict of interest that precludes the insurer from assuming the insured's defense." *See Employers Ins. of Wausau*, 708 N.E.2d at 1137. Even in such a case, however, in order to avoid the estoppel rule, the insurer must reimburse the insured for the costs of the defense as they are incurred. *Id.*

And that is exactly what the district court did. It stated that the estoppel doctrine had not been applied by a Rhode Island court since *Conanicut* (although it does not appear it has been rejected) and it pointed to statements by the Rhode Island Supreme Court that "estoppel could *not* be invoked to expand the scope of coverage in an insurance policy" (although the court did not consider the specific issues before the court in those cases). *Id.* (citations omitted). For these reasons, the *Emhart Industries* court suggested that the estoppel doctrine as pronounced in *Conanicut* "has lost its persuasive force." *Id.* at 262. In rejecting the estoppel doctrine, the court stated that:

> If the Rhode Island Supreme Court wishes to impose such a drastic penalty on breaching insurers as a mechanism to police the *limites* of the duty to defend, it could of course, do so in this or any other context. But federal courts are not sounding boards for avant-garde theories of insurance law.

Id. On appeal, the First Circuit upheld the rejection of the estoppel doctrine and stated that it "doubted" that *Conanicut* "could be read as imposing a bright line rule for the imposition of damages." *Emhart Indus., Inc. v. Century Indem. Co.*, 559 F.3d 57, 77 (1st Cir. 2009).

C. <u>Limited Estoppel Doctrine</u>

The cases discussed above demonstrate that there remains some uncertainty in the application of the estoppel doctrine. This uncertainty is further evidenced by the fact that some jurisdictions have carved out a middle ground between rejecting and accepting automatic estoppel. This approach can be generally thought of as a "limited" estoppel doctrine, and has been adopted most notably in California. Courts applying this limited estoppel doctrine recognize that some consequence beyond defense costs must be borne by the breaching insurer, but they do not go so far as to hold that insurers waive coverage defenses in all cases. Instead, the estoppel rule will not apply unless the insurer acted unreasonably or in bad faith.

Early cases discussing the estoppel rule in California appear to apply the rule without any limitation. In the well-known case *Gray v. Zurich Insurance Co.*, 419 P.2d 168 (Cal. 1966), the Supreme Court of California made the sweeping proclamation that "the general rule [is] that an insurer that wrongfully refuses to defend is liable on the judgment against the insured." *Id.* at 179. This statement that an insurer forfeits coverage defenses by "wrongfully" denying a defense is the exact same language employed in jurisdictions applying the automatic estoppel rule. For example, in *Employers Ins. of Wasau*, the Supreme Court of Illinois stated that where an insurer "wrongfully denied coverage, the insurer is estopped from raising policy defenses to coverage"). 708 N.E.2d at 1135. While Illinois and California articulate the standard the same way, the law has developed differently in practice. Illinois appears to interpret the word "wrongfully" to mean that estoppel shall be applied where the denial of a defense was "wrong," or incorrect. Thus, whenever the insurer has breached the duty to defend, estoppel applies. In California on the other hand, courts have interpreted the term "wrongful" to mean "in bad faith." Thus, estoppel will only apply if the insurer unreasonably or in bad faith denied a defense. *See, e.g.*, *Amato v. Mercury Cas. Co.*, 53 Cal. App. 4th 825 (Cal. Ct. App. 1997) (holding that insured could recover cost of underlying judgment after breach of duty to defend even though judgment was not on a covered claim because insurer acted unreasonably and in bad faith in denying defense); *see also Mut. of Enumclaw Ins. Co. v. Dan Paulson Constr., Inc.*, 169 P.3d 1, 10 (Wash. 2007) ("if the insured prevails on the bad faith claim, the insurer is estopped from denying coverage") (citation omitted).

This limited version of the estoppel doctrine is the subject of much confusion. In fact, some commentators have stated that California has adopted the estoppel doctrine, while others proclaim that California has rejected it.[12] Not only does the rule not lend itself to easy

[12] *Compare* Weiss, *supra,* n.6, at 154 *with* Gary L. Gassman et al., *Potential Consequences of Breaching the Duty to Defend: Key Considerations for Insurers and their Attorneys,* The Brief, Vol. 45, Fall 2015, at 33.

classification, but also it appears difficult to enforce. If estoppel in California requires a showing of bad faith, then how is it different from a tort claim for bad faith? What benefit does the insured derive from the estoppel rule that it could not already obtain from a bad faith action? The answer appears to be simply that the insured need not plead a tort claim, but could instead use the bad faith estoppel principle as a means for obtaining tort damages in a contract action. The rule in California invites even further confusion by creating a scenario in which two lines of cases regarding bad faith develop – one addressing tort claims and the other addressing estoppel. This result could lead to inconsistencies in the law and uncertainty for both the insured and the insurer.

Despite this confusion, the "limited" estoppel doctrine appears to be gaining traction. In 2014, the American Law Institute ("ALI") proposed the creation of the first Restatement of the Law of Liability Insurance.[13] As the draft currently stands, it adopts a limited estoppel doctrine, which states: "An insurer that lacks a reasonable basis for its failure to defend a legal action also loses the right to contest coverage for the action."[14] The comments elaborate that "a reasonable basis" "means that the insurer has a reasonable legal theory pursuant to which, giving the insured the benefit of the doubt with regard to any and all disputed facts, the insurer has no duty to defend as a matter of law."[15]

In sum, the limited estoppel doctrine appears to impose a consequence on insurers for breaching the duty to defend, but in reality it does so only in certain circumstances. The limited

[13] At the time of the drafting of this Article, the Council of the American Law Institute had drafted and approved two of the four chapters of the proposed Restatement, including Section 19, "Consequences of Breach of the Duty to Defend," subject to the approval of ALI membership. For a thorough and compelling analysis of a preliminary draft of the Restatement, *see* Timothy P. Law & Lisa A. Szymanski, *Reserving the Right to Contest Coverage under the Proposed Restatement of the Law of Liability Insurance*, 68 Rutgers U. L. Rev. 29 (2015).

[14] Restatement of the Law of Liab. Ins. § 19(2) (Am. Law Inst., Council Draft No. 2, December 28, 2015).

[15] Restatement of the Law of Liab. Ins., *supra* note 14 at comment d.

estoppel doctrine changes the equation only by allowing some additional recovery if the insurer acted in bad faith. In a state with strong bad faith protections, this may not add much to the equation – the insured can already recover potentially substantial punitive damages that would compensate for the amount of the judgment or settlement. The added protection may be a material difference only in states with limited bad faith recoveries. On the other hand, the limited estoppel doctrine provides no added protection for an insured where the insurer had a reasonable basis to deny coverage. Thus, the insured would still be left without any protections for the intangible benefits that it was denied. If the limited estoppel doctrine adds protections in only a narrow set of circumstances, one may question whether it is worth having at all.

V. CHALLENGING UNDERLYING ATTORNEY FEES AFTER BREACH

Having examined the nuances in determining a breach and litigating coverage, we now turn back to the uncontroversial remedy for the breach of the duty to defend: the recovery of attorneys' fees incurred in the underlying litigation. Generally, most jurisdictions allow an insurance carrier to challenge the reasonableness of attorney fees incurred in the underlying litigation.[16] However, some states impose a presumption that the fees were reasonable, thus shifting the burden to the carrier to prove that the fees were unreasonable.[17]

The main rationale for application of the burden shifting scheme is that, when an insurer has breached the duty to defend and the policyholder has secured, supervised, and paid for a

[16] *See House of Clean, Inc. v. St. Paul Fire & Marine Ins. Co.,* 775 F. Supp. 2d 302, 309 (D. Mass. 2011) ("Even where the insurer has breached its duty to defend, the insured must prove the existence and amount of the expenses and that those expenses were reasonable and necessary defense costs."); *Emhart Indus., Inc.* 515 F. Supp. 2d at 251 ("the general rule in these situations is that the initial burden is on the insured to prove that its fees were reasonable"); *Etchell v. Royal Ins. Co*., 165 F.R.D. 523, 545 (N.D. Cal. 1996) (stating that, even after a breach, insureds bear "the burden of proving that the hourly rates on which the fee claims are based were reasonable").

[17] *See Taco Bell v. Cont'l Cas. Co.,* 388 F.3d 1069, 1075-77 (7th Cir. 2004); *Gustafson v. Am. Family Mut. Ins. Co*., 2012 WL 5904301, at *5 (D. Colo. Nov. 26, 2012) ("The Court finds that, in accordance with general principles of contract law, the Colorado Supreme Court would place the burden of proving the reasonableness of attorneys' fees on the insurer who breached its duty to defend."); *Shore Chan Bragalone Depumpo LLP v. Greenwich Ins. Co.,* 904 F. Supp. 2d 592, 603 (N.D. Tex. 2012) ("insurer who abdicates its duty to defend is also barred from directly challenging the reasonableness and necessity of the insured's attorney's fees").

defense without any assurance that it would be reimbursed by the insurer, those costs are "market tested" and are presumed to be reasonable and necessary. *See Taco Bell v. Continental Cas. Co.*, 388 F.3d 1069, 1075-77 (7th Cir. 2004). This is because a policyholder, who is spending its own money without any assurance that it will ever be reimbursed by an insurer, is already motivated to be as efficient as possible, and thus its efforts to economize its own defense provide a market-based check on the amounts spent.

In *Taco Bell*, the insurer – having been found to have breached the duty to defend – argued that the insured had overpaid its lawyers in the underlying litigation. The Seventh Circuit rejected the argument:

> When Taco Bell hired its lawyers, and indeed at all times since, Zurich [has] vigorously den[ied] that it had any duty to defend –any duty, therefore, to reimburse Taco Bell. Because of the resulting uncertainty about reimbursement, Taco Bell had an incentive to minimize its legal expenses (for it might not be able to shift them); and where there are market incentives to economize, there is no occasion for a painstaking judicial review.

Id. at 1075-76. The court explained that "the duty to defend would be significantly undermined if an insurance company could, by the facile expedient of hiring an audit firm to pick apart a law firm's billing, obtain an evidentiary hearing on how much of the insured's defense costs it had to reimburse." *Id.* at 1077. The court reasoned that it is unfair to let a breaching insurer quibble over costs when it could have initially directed the defense in any reasonable way it wished if it had honored its duty to defend in the first place. *Id*. at 1076-77; *see also Knoll Pharm. Co. v. Auto. Ins. Co. of Hartford*, 210 F. Supp. 2d 1017, 1025 (N.D. Ill. 2002) (insureds' payment of all defense costs sought from insurer "strongly implies commercial reasonableness of the fees, especially in light of the fact that ultimate recovery of these fees was uncertain because [the insurers] repeatedly refused to pay"); *Medcom Holding Co. v. Baxter Travenol Labs., Inc.,* 200 F.3d 518, 520 (7th Cir. 1999) ("The fees in dispute here are not pie-in-the-sky numbers that one litigant seeks to collect from a stranger but would never dream of paying itself. These are bills that [the plaintiff] *actually paid* in the ordinary course of its business."). Thus, these courts reason that an insured's contemporaneous efforts to minimize its own defense expenses are superior to any hindsight review applied by a breaching insurer.

It is crucial to note that while these cases appear to discourage a "painstaking judicial review" of the insured's defense fees, they do not unequivocally preclude such an undertaking. Instead, the remedy applied is merely a shift of the burden of proof – the insurer is still entitled to present evidence of unreasonableness. Thus, courts applying the burden shifting analysis often must still undergo an examination of the individual expenses incurred. For example, in *Thomson Inc. v. Insurance Company of North America*, 11 N.E.3d 982 (Ind. Ct. App. 2014), the trial court held that, due to the breach of the duty to defend, the insured's defense costs were "presumed to be reasonable and necessary" and "the insurer cannot second guess the work done or amounts paid . . . ." *Id.* at 1024. However, the trial court still allowed the insurer to present expert evidence criticizing the general billing practices employed by the insured's underlying counsel. A battle of the experts ensued in which the insurer presented an expert who was not a litigator, but specialized in "reviewing legal bills and identifying practices he claims lead to overbilling." *Id.* at 1025. The insured's expert, on the other hand, was a partner at Vinson & Elkins who had defended similar cases in similar jurisdictions. The court found the insured's expert to be more persuasive, particularly because he applied the factors for determining the reasonableness of fees as set forth in the Indiana Code of Professional Conduct, which requires that the court consider "novelty, difficulty, skill, experience, reputation, and ability." *Id.* Thus, despite the application of the burden shifting presumption, the parties were still permitted to submit detailed expert opinions analyzing the particulars of the insured's attorneys' billing practices and the court undertook an analysis of that evidence. The Court of Appeals agreed with this approach and affirmed the trial court's opinion. *Thomson* is a prime example of the fact that, even where courts apply the presumption of reasonableness, it may not substantially alter the proceedings. The insurer is still entitled to submit evidence that the defense fees were unreasonable, which results in the same detailed analysis of the legal fees and battle of the experts that would take place in the absence of the presumption.

VI. CONCLUSION

The issues and cases discussed herein represent only part of the many complications facing litigants after the duty to defend has been breached. A possible explanation for the myriad and conflicting responses to these issues may simply be that the underlying problems are difficult ones. As such, intelligent litigators and courts reasonably disagree as to the outcome of such controversies. Courts struggling with different problems are bound to come up with different resolutions. In an area where many rationalizations and justifications may have traction, good advocacy and an understanding of the fundamental issues could make all the difference.