THE TREATMENT OF INSURERS' DEFENSE-RELATED RESPONSIBILITIES IN THE PRINCIPLES OF THE LAW OF LIABILITY INSURANCE: A CRITIQUE[1]

Charles Silver & William T. Barker***

I. INTRODUCTION

Once the American Law Institute ("ALI") converts the Principles of the Law of Liability Insurance[2] (the "Principles") to a Restatement (as it now plans to do), the common law of insurance will never be the same. The ALI's Restatements exert great influence on judges, all of whom take these volumes seriously and some of whom rely on them reflexively. Why spend precious time studying arcane areas of doctrine or pondering difficult, undecided questions of law when the best scholars in the land

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1. This Article complements William T. Barker, *The American Law Institute Principles of the Law of Liability Insurance: Part II--Selected Comments from an Insurer Perspective*, *in* NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW (2015) [hereinafter, Barker, *Selected Comments*], by providing further analysis regarding defense issues and extending Mr. Barker's critique of using ancillary rules to stretch coverage, absent special justification for doing so.

* McDonald Endowed Chair in Civil Procedure, School of Law, University of Texas at Austin. Professor Silver was an Associate Reporter on the American Law Institute's Principles of the Law of Aggregate Litigation.

** William T. Barker is a member of the Insurance Litigation & Coverage Practice Group of Dentons US LLP, practicing in its Chicago office, with a nationwide practice, primarily representing insurers in the area of complex insurance litigation, including coverage, claim practices, sales practices, risk classification and selection, agent relationships, and regulatory matters. He is the co-author (with Ronald D. Kent) of New Appleman Insurance Bad Faith Litigation, Second Edition and (with Professor Silver) of Professional Responsibilities of Insurance Defense Counsel. He is an Adviser to the American Law Institute project on Principles of the Law of Liability Insurance. He is a Vice Chair of the American Bar Association ("ABA") Tort Trial & Insurance Practice Section Insurance Coverage Litigation Committee and a co-chair of the Subcommittee on Bad Faith Litigation of the ABA Litigation Section Insurance Coverage Litigation Committee.

2. PRINCIPLES OF THE LAW OF LIAB. INS. (AM. LAW INST., Tentative Draft No. 2, 2014). The Principles also include Chapter 1, contained in Tentative Draft No. 1, but our focus in this Article is solely on Tentative Draft No. 2.

have already done the work for you? Because the temptation to follow the ALI's lead can be irresistible, it is essential for the Reporters, Professors Tom Baker and Kyle Logue,[3] to offer an account of liability insurance law that is both analytically defensible and correct in its practical details.

The importance of offering the best possible account is underscored by the fact that, in important respects, the law of liability insurance is still in flux. In some states, the highest civil courts have yet to rule upon important questions. In others, the highest courts have ruled but have reached incompatible results. Want to know whether a liability insurer is a client of the lawyer it engages to defend a liability suit? The Supreme Court of Texas will give you one answer, the Supreme Court of Michigan will give you another, and the Supreme Court of Colorado has not said.[4] When courts are divided or undecided, volumes like the Principles, let alone a Restatement, can influence the law's future evolution greatly by offering what appears to be a consensus of informed and thoughtful people on relevant points.

Through the medium of popular film, Voltaire's observation that "with great power comes great responsibility" has become commonplace, and it is clear that Professors Baker and Logue have shouldered their responsibilities admirably. The black-letter provisions, Comments, and Reporters' Notes they have written are admirably clear, pointed, and concise. They deserve praise for being candid and fair as well. Throughout the Principles, they identify majority and minority positions, and they state forthrightly which view they prefer and why. A person who studies the Principles with care will gain a good education in liability insurance law and will also learn that, by putting Professors Baker and Logue in charge of this project, the ALI chose well. Even readers who disagree with some of their most important doctrinal choices, as we do, must concede that their desire to figure out and embrace the best possible view of the law is clear.

In this essay, we focus on the sections in Tentative Draft No. 2 of the Principles that address liability carriers' rights and duties relating to the defense of lawsuits against the people and businesses they insure. Although we find much to admire in these sections, we find much to criticize as well. At the highest or most abstract level, we believe that these sections are under-theorized. On parsing them with care, one sees that the Reporters often disregard the contractual logic of insurance for reasons that are obscure.

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3. *Id.* foreword at xi.

4. WILLIAM T. BARKER & CHARLES SILVER, PROFESSIONAL RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL § 4.04[4] (2015) (surveying authority).

This is true, for example, in section 15, where the rules set out in the Principles require insurers to take extrinsic facts into account for the purpose of triggering the defense obligation but forbid them from considering the same information for the purpose of negating it.[5] Yet, the argument that supports the requirement shows that extrinsic facts have value for both purposes. Consequently, the one-way approach embraced in section 15 seems ad hoc and unjustified.

The doctrines advanced in sections 21 and 25, which penalize insurers that breach the duty to defend by denying them the right to contest coverage for liability claims,[6] also seem theory-poor. Remedies for breach of contract are supposed to restore parties to the position they would have come to had their counterparts performed.[7] It follows that liability insurers should hold policyholders harmless from consequences caused by a wrongful failure to defend. But the penalty endorsed in sections 21 and 25 does more than this. It frees policyholders from a burden they would have carried had no breach occurred. The reason for penalizing insurers in this way is never convincingly explained.

The sections in the Principles that govern the duty to defend also have problems at the ground level. One of the more serious of these is that some rules embraced in the Principles seem to conflict with or deviate from rules the ALI previously approved in connection with other projects. For example, the confidentiality rules set out in sections 13 and 16 of the Principles[8] appear to be at odds with those endorsed in the Restatement (Third) of the Law Governing Lawyers ("Rest-LGL").[9] Where the former sections assert that policyholders' communications with defense counsel are privileged from discovery by insurers and require defense lawyers to protect policyholders by keeping secrets,[10] the latter denies that a privilege exists and requires free and open communication.[11] Section 16 of the Principles also seems to require defense lawyers to obtain conflict waivers from liability insurers while withholding important information.[12] The Rest-LGL requires lawyers to inform clients fully when asking them to waive conflicts.[13]

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5. *Id.* § 15 cmt. a.
6. *Id.* §§ 21(1), 25(2)(d).
7. RESTATEMENT (SECOND) OF CONTRACTS § 344(a) (AM. LAW INST. 1981).
8. *Id.* §§ 13(2), 16(1)(c).
9. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 (AM. LAW INST. 2000).
10. PRINCIPLES OF THE LAW OF LIAB. INS. §§ 13(2), 16(1)(c) (AM. LAW INST., Tentative Draft No. 2, 2014).
11. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 (AM. LAW INST. 2000).
12. *See* PRINCIPLES OF THE LAW OF LIAB. INS. § 16(1)(c) (AM. LAW INST., Tentative Draft No. 2, 2014).
13. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 62 (AM. LAW INST. 2000).

This Article proceeds as follows. Part II provides background on the duty to defend, the duty to indemnify, and the majority and minority rules governing the consequences insurers suffer after failing to defend when they should. Part III discusses the rule imposing forfeiture of coverage defenses as a penalty for breach of the duty to defend. Part IV discusses use of extrinsic evidence to deny a defense. Part V discusses the special rules governing conduct of the defense. Part VI examines the propriety of rules, like those discussed here, which force or pressure insurers to provide protection against non-covered risks. Part VII urges reconsideration of such rules as the Principles are converted to a Restatement.

II. BACKGROUND ON INSURERS' DEFENSE-RELATED RESPONSIBILITIES AND THEIR TREATMENT IN THE PRINCIPLES

Liability insurance policies contain a variety of provisions that govern carriers' responsibilities relating to the defense of claims.[14] At one end of the spectrum lie pure indemnity policies which disclaim all such responsibilities, including coverage for defense costs. At the other end are policies that require carriers to defend claims themselves, that entitle them to exclude policyholders from defense-related decisions, and that place no limit on the amount of defense costs they must bear.[15] The following questions help identify the lines along which policies vary:

- Is the carrier responsible for defense costs? If so, must the carrier pay those costs directly or reimburse the policyholder for them? If the latter, must reimbursement occur while litigation is underway or after it concludes? If the carrier must pay defense costs, is its exposure to these costs limited or unlimited, and if limited, in what way? If the carrier is responsible for defense costs, is it also obligated to indemnify the insured on the liability claim or did it sell stand-alone coverage for defense costs?

- Does the carrier have a duty to handle the defense or is the policyholder responsible for hiring defense counsel and making defense-related decisions? If the latter, is the carrier entitled to associate in the defense and, if so, to what extent? If the former, does the carrier also have a right to control the defense, to the exclusion of the insured?

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14. PRINCIPLES OF THE LAW OF LIAB. INS. § 12 cmt. a (AM. LAW INST., Tentative Draft No. 2, 2014).

15. *See id.* § 12 cmt. b.

By setting out these questions, we are implicitly telling readers two things. First, the answers to them are important. They help one understand the duties carriers owe policyholders, which matter when it comes to understanding the remedies that should be available to policyholders when insurers fail to perform. Second, the answers can vary. Insurance contracts are often said to be standardized and, in fact, policies sold by different carriers to cover the same risks in the same contexts often contain similar provisions.[16] But insurance is sold in many contexts to policyholders of different types, and across contexts and policyholders the forms differ considerably. Presumably, the differences reflect underlying structural considerations, such as differences in the risks presented, as well as policyholders' differing abilities and needs.

For example, people who buy personal lines coverage for their automobiles or homes typically lack both the sophistication and the financial wherewithal needed to handle the defense of liability suits. Personal lines policies therefore obligate insurers to provide both services, using language that gives them the right and the duty to defend lawsuits that seek damages covered by the policies' indemnity provisions.[17] Typically, the insurer's responsibility for defense costs is unlimited,[18] except that it ends when the limits on the indemnity coverage are exhausted by settlements or judgments. These provisions differ greatly from those commonly found in policies that cover the liabilities of the directors and officers of public companies. "D&O" policies typically require policyholders to defend claims. They entitle insurers to associate in the defense, require them to indemnify defense costs (perhaps by advancing money to the insured), may set a retention below which policyholders are on the hook financially, and provide that dollars spent defending claims erode the available liability coverage and may even exhaust it. The more prominent role played by policyholders reflects the greater sophistication of corporate directors and officers, the relative ability of corporations to bear costs, and the greater likelihood of defense-related conflicts among insureds on the same policy.

The Principles recognize many of the differences between insurance policies that interest us. For example, in sections 16 and 21, rules are provided for duty-to-defend policies; those rules require insurers to both

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16. The extent to which homeowners insurance policies are standardized is studied in Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263 (2011).

17. *See* Seth D. Lamden, *Duty to Defend*, *in* 3 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 17.01[1][a]–[b] (Jeffrey E. Thomas & Francis J. Mootz III, eds., 2015).

18. PRINCIPLES OF THE LAW OF LIAB. INS. § 16(3) (AM. LAW INST., Tentative Draft No. 2, 2014).

bear defense costs and conduct the defense.[19] Defense cost indemnification policies, which only require carriers to reimburse defense costs that policyholders incur, are addressed in section 25.[20] The Principles also consider, in section 12, the right to defend, which, when it exists, normally entitles carriers to exclude policyholders from defense-related decisions.[21] By saying that insurers' defense-related responsibilities and rights vary, we are not telling the Reporters anything they do not already know.

When it comes to deciding which remedies ought to be available when carriers breach their defense-related responsibilities, the rules stated by the Principles provide that some basic differences between insurance policies do not matter. Thus, although duty-to-defend policies are addressed in section 21 and defense-cost reimbursement policies in section 25,[22] the same remedies are provided in both. The black-letter for section 21 states that "[a] liability insurer that breaches the duty to defend a claim loses the right to defend or associate in the defense of the claim, the right to assert any control over the settlement of the claim, and the right to contest coverage for the claim."[23] The black-letter for section 25 states that "[a]n insurer that breaches this defense-cost obligation loses the right to associate in the defense of the claim[,] . . . the right to exercise any control in the settlement of the claim, and the right to contest coverage for the claim."[24]

Because the duty to defend saddles an insurer with more burdensome responsibilities than the duty to indemnify, the identical treatment of breaches may seem surprising. As set out in section 16, a carrier that has a duty to defend a lawsuit must provide a defense that meets professional standards, is reasonably calculated to protect the insured from all risks posed by the liability suit (including risks that fall outside the scope of insurance coverage), and keeps confidential from the insurer information that could be used to the detriment of the insured.[25] The carrier must also pay defense costs without limit, unless the policy provides for a cap.[26] Under a defense-cost indemnification policy, a carrier has only the obligation to pay.[27] Yet, even though a policyholder relies upon a carrier with a duty to defend to provide a broader range of services, the remedies

19. *Id.* §§ 16, 21.
20. *Id.* § 25.
21. *Id.* § 12(1).
22. *Id.* §§ 21, 25.
23. *Id.* § 21(1).
24. *Id.* § 25(2)(d).
25. *Id.* § 16(1)(a)–(c).
26. *Id.* § 16(3).
27. *Id.* § 25.

made available in the Principles for breach of the duty to defend are the same as those for breach of the duty to reimburse.[28] The Reporters evidently believe that the duty to pay carries all the freight.

Insofar as the obligation to bear defense costs is concerned, a breach occurs when a carrier fails to step up to the plate. This may happen for many reasons. For example, the carrier may wrongly believe that the damages sought in the liability suit fall outside the coverage provided by the policy's indemnity provisions, that the insured committed a fraud or misrepresentation when applying for coverage, or that the insured failed to cooperate or to provide timely notice of the accident upon which the claim is based. An insurer with a full-blooded duty to defend (as contrasted with solely a duty to pay for the defense) may breach in ways other than just by failing to shoulder costs. It may fail to defend altogether, conduct the defense negligently, favor itself to the detriment of its insured, or wrongly acquire an insured's confidential information.

Obviously, for a breach to occur, the duty to defend must first be triggered. Ordinarily, the existence of a duty to defend is determined solely by examining the allegations found in the complaint against the insured in light of the insurance policy's coverage provisions.[29] This is variously described as the complaint-allegation rule or the rule requiring coverage to be determined by alleged facts within the "four corners" of the complaint or the "eight corners" of the complaint and the insurance policy.[30] Some form of this rule (sometimes referred to as the "exclusive pleading rule") is followed in all American jurisdictions.[31]

In comparison to the ordinary way of determining whether a party had a duty to perform under a contract, the complaint allegation rule is odd. When one party sues another for breach of contract, the court ordinarily examines the actual facts relevant to the contractual duty and determines, based on those facts, what the contract required and whether the promised performance was rendered. It does not matter what one party thought were the facts or what some third party alleged were the

28. *Compare id.* § 21 (requiring forfeiture of defenses to a claim for coverage, damages, and the right to assign the claim to another claimant or insurer), *with id.* § 25 cmt. c ("A breach of the duty to pay defense costs . . . exposes the insurer to consequences that are similar to those of a breach of the duty to defend under § 21.").

29. *See* Lamden, *supra* note 17, at 17.01[2][a]; Barker, *Selected Comments*, *supra* note 1, at 4.

30. An extensive collection of cases on this issue can be found in C. T. Drechsler, Annotation, *Allegations in Third Person's Action Against Insured as Determining Liability Insurer's Duty to Defend*, 50 A.L.R.2d 458, § 4 (1956 & Supp. 2006).

31. *See* Paul E.B. Glad, Ronald D. Kent, & Michael Barnes, *Understanding Liability Insurance*, *in* 3 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE § 30.14[3][b] (Jeffrey E. Thomas et al. eds., 2015) (discussing variations).

facts. The actual facts, as found by the court, determine whether there was an obligation to perform. Not only is this the rule for contracts generally, it is also the usual rule for insurance policies. It applies when an insured seeks first-party benefits for the insured's own loss (e.g., disability or damage to insured property). It also applies under liability insurance policies when the insured seeks indemnification for a judgment or settlement. Only the duty to defend depends (most of the time) on unproven allegations about the facts. Why is this?

At the deepest level, the complaint allegation rule derives from the nature of defense-related insurance coverage. Defense-related responsibilities arise when policyholders face lawsuits that seek damages covered by their insurance. Whether covered damages are sought obviously depends on the content of the complaint—not on the actual facts, which may not support covered liabilities or, indeed, warrant the imposition of any liabilities at all. As long as the content of the complaint creates the potential for coverage under the policy, the insurer's defense-related responsibilities are triggered. Thus, the language and logic of the insurance contract dictate that existence of the duty must ordinarily be determined from the allegations of the complaint.[32]

But, as a logical matter, when the potential for coverage is taken as the standard, the allegations in a complaint need not always be dispositive. They could (at least sometimes) be trumped by extrinsic facts, i.e., facts that are not alleged in a complaint but that are known to an insurer. Again, solely as a matter of logic, extrinsic facts could influence the potential for coverage in two ways. They can create it when the allegations in a complaint fail to do so, and they can negate it when, given only the allegations in a complaint, it would otherwise exist.

Consider how extrinsic facts could be used inclusively, that is, to create a potential for coverage in the absence of coverage-triggering allegations in a complaint. Suppose that Policyholder owns two vehicles, Car A and Car B, but purchases insurance for only Car A. Now suppose that Policyholder is involved in an accident with Driver while driving Car A. Finally, suppose that Driver sues Policyholder but that the complaint mistakenly states that Policyholder was driving Car B. The complaint, standing alone, would not trigger the duty to defend because the allegation is that Car B was involved in the accident and Car B is not insured. But if the insurer learned from another source (such as the accident report or Policyholder) that Car A was involved, a potential for coverage could be deemed to exist and the insurer could have to defend the case.

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32. *See* Barker, *Selected Comments*, *supra* note 1, at 4.

Now consider how extrinsic facts could be used exclusively, that is, to negate a potential for coverage that would otherwise exist. Suppose that, as before, Policyholder has coverage for only Car A. Now suppose that the accident involved Car B. Finally, suppose that Driver's complaint mistakenly states that Policyholder was driving Car A. The complaint would trigger the duty to defend because it alleges that the accident involved the covered automobile. But if the insurer knows that Car B was involved (perhaps because the accident report says so or Policyholder admitted it), a duty to defend might not exist because Car B was not insured.

The argument for allowing extrinsic facts to trump the allegations in a complaint is simple. Were their use prohibited, the bargains struck by insurers and policyholders would be distorted. Policyholders would sometimes benefit by having insurers defend lawsuits with no potential to generate covered damages, and insurers would sometimes benefit by avoiding the duty to defend lawsuits with this potential. If insurers were allowed to use extrinsic facts exclusively and required to use them inclusively, both distortions could be avoided. Insurers would defend only and all lawsuits with the bona fide potential to create covered losses.

To be clear, the point is *not* that extrinsic facts can defeat the potential for coverage by negating a policyholder's liability on a claim which, if valid, would generate a covered loss. The point is only that they can do so by establishing that no coverage would exist even if the claimant were to prevail against the insured at trial. Where the insured is alleged to be liable for a claim that would be covered if proven, the insurer has contracted to satisfy the court, if possible, that the claim is without merit. Refutation of allegations supporting the insured's liability is part of the required defense, not a basis for refusing to defend.[33]

Turning from logic to law, as a doctrinal matter, the use of extrinsic facts inclusively is not controversial. It is widely held that, even if the underlying complaint does not state facts bringing the claim within the policy's coverage, "an insurer may also be required to defend if the insurer possesses knowledge of true but unpleaded facts that, when taken together with the allegations in the complaint, indicate that the claim is within or potentially within the policy coverage."[34] Accordingly, the rules stated by the Principles in section 15 require insurers to use extrinsic facts inclusively.[35] As the Comment on this section states:

33. *See id.* at 5–7.

34. Nat'l Union Fire Ins. Co. v. R. Olson Constr. Contractors, Inc., 769 N.E.2d 977, 981 (Ill. Ct. App. 2002) (citing Shriver Ins. Agency v. Utica Mut. Ins. Co., 750 N.E.2d 1253, 1256 (Ill. Ct. App. 2001)).

35. PRINCIPLES OF THE LAW OF LIAB. INS. § 15(2) (AM. LAW INST., Tentative Draft No. 2,

> If the complaint or comparable document does not contain an allegation triggering the duty to defend a claim, the insurer has a duty to defend the claim only if the insurer knows or reasonably should know of other information that would lead a reasonable insurer to conclude that the claim is based on an allegation that, if included in the complaint, would require the insurer to defend.[36]

But the rules stated by the Principles would prohibit insurers from using extrinsic facts exclusively, that is, to negate the potential for coverage created by a complaint. They emphasize that the rule governing the use of extrinsic facts "works in one direction only."[37] Although extrinsic facts must be used inclusively, the Principles provide that, with but two noted exceptions,[38] exclusive uses are forbidden: "[F]acts or circumstances not alleged in the complaint or comparable document may not be used to justify a refusal or failure to defend."[39] The argument given for the one-way approach is that "[t]his widely accepted rule reflects a public policy of construing defense coverage broadly. The complaint-allegation rule and the one-way use of information beyond the complaint are two of the most important ways in which the duty to defend is broader than the duty to indemnify."[40]

As recognized by the Principles, not all jurisdictions use the approach endorsed in section 15.[41] Some permit insurers to use extrinsic facts exclusively.[42] In these "all-the-facts-and-circumstances" jurisdictions:

> [T]he insurer in deciding whether to provide a defense of a claim may take into account any and all circumstances that bear on whether the claim is covered. Thus, for example, even if a complaint is filed that contains facts that, if proven, would give rise to a covered claim, the insurer can decline to defend the case under the facts-and-circumstances approach, without resort to a

2014).

36. *Id.* § 15 cmt. c.

37. *Id.*

38. The Principles would permit insurers to use extrinsic information exclusively when determining whether a person or entity is an insured and whether the events alleged to give rise to the claim occurred within the policy period. *See id.* § 15(3). Extrinsic facts may also be offered in declaratory judgment actions where the existence of coverage is determined. *See id.* § 20 cmt. j.

39. *Id.* § 15 cmt. c.

40. *Id.*

41. *Id.* § 15 cmt. f.

42. *Id.*

> declaratory-judgment action, if the insurer decides that facts outside of the complaint demonstrate that the claim is not covered. Under this approach, a breach of the duty to defend is found only if it is subsequently determined that the insurer was wrong about the facts and circumstances.[43]
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> According to the Principles,
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> [t]he problem with th[at] approach is the uncertainty it creates for the insured. The possibility of bringing a subsequent case against the insurer for breach of the duty to defend will be of little comfort to insureds, who will find such litigation expensive and daunting. By contrast, under the [approach endorsed in section 15], there is substantially less uncertainty borne by insureds regarding when they can expect to receive a defense from their liability insurer. So long as the complaint contains allegations that if proven true would be covered, or the insured can offer evidence outside of the complaint that supports coverage, the insured can be confident of receiving a defense.[44]

Plainly, the object of this rule is to make paid defenses available to policyholders more often than is the case in jurisdictions that follow the "all-the-facts-and-circumstances" approach.[45]

III. INSURERS THAT BREACH THE DUTY TO DEFEND SHOULD BE ALLOWED TO CONTEST THE EXISTENCE OF COVERAGE

As mentioned, two sections of the Principles provide for a variety of penalties to be imposed upon insurers that breach the duty to defend. In this Part, we focus on one penalty: the loss of the right to contest coverage for the liability claim.[46] The arguments in support of this penalty appear in the Comments to sections 21 and 25.[47] Before addressing these justifications, we remind readers of a point made above: in both sections, the duty to bear defense costs does the heavy lifting. Although other responsibilities associated with the duty to defend, such as the duty to manage the defense, might conceivably provide a basis for the penalty, no such ancillary responsibilities exist under the

43. *Id.*
44. *Id.*
45. *See id.*
46. *Id.* §§ 21(1), 25(2)(d).
47. *See id.* §§ 21 cmt. c, 25 cmts. c & e.

reimbursement policies that are governed by section 25. These policies impose only a duty to pay but are subject to the same remedies for breach, as previously explained.[48]

Because reimbursement policies entail fewer responsibilities than duty-to-defend polices, we begin by examining the Reporters' analysis of them. If the reasons offered in section 25 in support of the penalty are determined to be good ones, the need to consider additional reasons that apply only to duty-to-defend policies will disappear, the reasons supporting the penalty in section 25 being sufficient to support the availability of the penalty under section 21 as well. Of course, if the reasons offered in section 25 are unpersuasive, the justifications offered in section 21 that apply uniquely to duty-to-defend policies will have to be considered as well.

The analysis supporting the availability of the penalty in section 25 appears in two comments.[49] One, entitled "Loss of coverage defenses," explains why the penalty *is* appropriate under policies that require carriers to reimburse policyholders for defense costs on an ongoing basis:

> *Loss of coverage defenses.* A breach of the duty to pay defense costs on an ongoing basis under a defense-cost indemnification policy exposes the insurer to consequences that are similar to those of a breach of the duty to defend under § 21. In particular, an insurer that breaches the duty to pay defense costs on an ongoing basis loses its coverage defenses. Almost without exception, courts that have considered this question treat such defense-cost indemnification policies identically to duty-to-defend policies in this regard, on the grounds that both policies promise to provide the same access to an insurer-funded defense. Like a breach of the duty to defend, a breach of the duty to pay defense costs may seriously compromise the insured's ability to obtain an adequate defense.[50]

A second comment explains why the penalty *is not* appropriate under policies that require carriers to reimburse policyholders at the conclusion of litigation:

> *When the duty to pay defense costs is not on an ongoing basis.* A retrospective defense-cost reimbursement policy does not raise the same access-to-justice concerns as a defense-cost

48. *Id.* § 25 cmt. c.
49. *Id.* § 25 cmts. c, e.
50. *Id.* § 25 cmt. c

> indemnification policy in which the insurer agrees to pay defense costs on an ongoing basis. A retrospective reimbursement policy does not promise to provide access to an insurer-funded defense. Rather, it promises to reimburse the insured, at the end of the process, for the costs of defending a covered claim. Whether the claim is covered is to be evaluated based on all of the information available at the time that reimbursement, if any, is owed. At that point the opportunity to defend the claim is over and, thus, none of the special rules that are designed to encourage the insurer to undertake the defense, or to pay the costs of defense on an ongoing basis, have any application.[51]

The point of these comments is straightforward. An insurer that breaches the duty to reimburse defense costs forfeits the right to contest coverage because the breach threatens to prevent the insured from obtaining an adequate defense by denying the insured access to resources on a timely basis. The penalty is unwarranted under policies that require carriers to reimburse policyholders after litigation concludes because the plain expectation is that the policyholders who purchase this form of coverage will provide the resources needed to pay for a defense throughout a lawsuit's duration.

The account provided in the Comment to section 25 has one thing going for it: it respects our observation that, in the case of defense-cost indemnification policies, the penalty of forfeiting the right to contest coverage cannot be tied to a service that an insurer might deliver while defending a claim itself, such as the management of counsel or the application of expertise acquired over decades of dealing with liability claims. When the defense obligation is merely to indemnify policyholders for defense costs, insurers provide no such services, as we explained. In keeping with this observation, the justification offered focuses on the policyholder's lost opportunity to provide itself with an adequate defense.

Still, on the grounds given, the decision to impose a penalty beyond ordinary damages seems odd. When damages are appropriately adjusted for delay in payment, resulting consequential losses, and any other relevant considerations, money provided at Time 2 is ordinarily an ideal remedy for money that should have been provided at Time 1, but was not. Monetary damages seem especially likely to suffice when a policyholder is wealthy enough to fund an adequate defense on its own, that is, without immediate help from a carrier. After bearing the cost of the defense initially, a wealthy policyholder can obtain reimbursement and

51. *Id.* § 25 cmt. e.

be as well off as if its insurer had performed instead of breaching the duty to reimburse.

It is reasonable to think that policyholders with reimbursement policies may often be able obtain access to justice despite insurers' failure to cover defense costs in a timely manner. For one thing, although most insureds are not wealthy, insurers typically sell defense-cost reimbursement policies only to policyholders who have sufficient assets to pay the costs and await reimbursement.[52] An insurer obliged to indemnify against judgments or settlements would not sell an impecunious person a policy of this type because it would not want to risk a defense impaired by the policyholder's inability to at least advance the costs of defense. This difference in the marketplace at least calls into question any parallelism in remedies to those for breach of a duty to defend. For another, defense costs are often manageable for some policyholders. Studying Texas claims covered by five lines of commercial insurance that closed with indemnity payments exceeding $25,000, researchers found median defense costs per claim ranging from a low of $12,000 for auto liability cases to a high of $38,000 for claims involving medical malpractice.[53] These being median figures, half the cases entailed lower costs. Although the study provided no information about the size of the businesses involved in these cases, one would think that many businesses could afford to bear costs of this magnitude, whether from existing assets or available financing.

Nothing in section 25 addresses either the type of policyholder to whom defense-cost reimbursement policies are sold or the factual point that defense costs are often low enough for some policyholders to manage. Both points force one to question the Reporters' assertion that a carrier's failure to provide funds on a timely basis "may seriously compromise the insured's ability to obtain an adequate defense."[54] In fact, this is an empirical assertion that is both unproven and likely often to be false for the group of policyholders to whom reimbursement policies are sold. Nor do the Reporters explain why insurers should suffer the penalty of forfeiting the right to contest coverage when policyholders are wealthy

52. William T. Barker & Ronald D. Kent, *Insurer Recoupment of Noncovered Settlements and Defense Costs*, *in* 3 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 23.11[d][iii] (Jeffrey E. Thomas & Francis J. Mootz III, eds., 2015).

53. Bernard Black et al., *Defense Costs and Insurer Reserves in Medical Malpractice and Other Personal Injury Cases: Evidence from Texas, 1988–2004*, 10 AM. L. & ECON. REV. 185, 203 tbl. 2 (2008). All figures are in 1988 dollars. If converted to 2015 dollars, the amounts would be roughly doubled. US INFLATION CALCULATOR, http://www.usinflationcalculator.com (last visited September 19, 2015).

54. PRINCIPLES OF THE LAW OF LIAB. INS. § 25 cmt. c (AM. LAW INST., Tentative Draft No. 2, 2014).

enough to defend lawsuits on their own. For example, a trucking company facing a claim for damage inflicted upon another vehicle by one of its own may be able to pay a lawyer until the claim is resolved and then fight over the carrier's duty to reimburse the cost. Because the concern expressed in the Principles—the loss of access to justice—would not arise in this situation, it is not obvious that the penalty provided for in the Principles would be warranted either.

The Reporters may have seen no need for evidence to support their access to justice argument because, as they point out, "[c]ourts in most of the states that have addressed the issue have treated the consequences of a breach of the duty to pay defense costs on an ongoing basis identically to a breach of the duty to defend."[55] The remedy appropriate for the latter is therefore also appropriate for the former. This formalism is too weak to bear the weight it is asked to carry, however, because most courts have *not* adopted the view that insurers forfeit the right to contest coverage by breaching the duty to defend.[56] As the Reporters candidly observe, the penalty they espouse "is the minority rule."[57] The majority rule, which allows a defaulting insurer to contest coverage for the liability claim, does not assume that a policyholder automatically loses access to justice or suffers any other consequential loss when an insurer fails to reimburse defense costs on a timely basis. It requires policyholders who wish to collect compensation for consequential damages to prove harm stemming from the breach. Not only is forfeiture of the coverage defense the minority rule, but it also contravenes the normal contractual rule that forbids penalties (as opposed to compensatory or substitutionary remedies) for a breach.[58] Justification for that rule demands evidence or argument showing that the penalty is warranted. None is provided.

By bearing defense costs itself, a wealthy policyholder would also satisfy the duty to avoid further losses, as codified in section 350 of the Restatement (Second) of Contracts.[59] Under that section, when one party fails to perform a contractual obligation, the other "is expected to take such affirmative steps as are appropriate in the circumstances to avoid

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55. *Id.* § 25 reporters' note c.

56. *Id.* § 21 reporters' note c.

57. *Id.*; *see also* 1 WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, § 3.08[2] (2d ed. 2015) ("The vast weight of authority rejects such a forfeiture of coverage defenses." (emphasis omitted)); 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSUREDS § 4:37 (5th ed. Supp. 2009) ("[A] handful of courts have held that an insurer will be precluded from denying coverage after it has unjustifiably refused to defend.").

58. RESTATEMENT (SECOND) OF CONTRACTS § 356 (AM. LAW INST. 1981).

59. *Id.* § 350.

loss by making substitute arrangements or otherwise."[60] Section 25 provides no reason for exempting a wealthy policyholder from the duty to make "substitute arrangements" for the defense of claims when an insurer fails to reimburse costs on a timely basis.[61]

Obviously, not all policyholders can afford to pay for legal services themselves after being denied coverage for defense costs by insurers. Lack of resources is likely to be a problem for most insureds covered by personal lines policies, such as those that protect homeowners and drivers. Although personal lines policies typically contain standard duty to defend provisions, not reimbursement clauses, insofar as the duty to pay is concerned, the two are substantially the same. Both require insurers to bear defense costs on a timely basis before litigation concludes. Consequently, the discussion of the problems faced by impecunious policyholders can encompass provisions of both types.

The first point to make about impecunious policyholders is that they rarely face significant financial exposure to judgments. By and large, plaintiffs' attorneys are not in the business of collecting judgments or settlements from individuals' personal assets. One of the Reporters, Tom Baker, made this point in an excellent article that has been cited widely.[62] Professor Baker argued that the practice of collecting only from insurers reflects a professional norm.[63] Other researchers have argued that the practice has a simple economic explanation: going after defendants' personal assets usually is more of a bother than it is worth.[64] Only when defendants are wealthy are sizeable gains to be had, and defendants with significant personal assets against which judgments can be collected are few and far between. Insofar as we know, no study has ever found that impecunious defendants face significant personal exposure on liability claims after being denied a defense by their insurers.

Because it is easier to collect from insurers than impecunious defendants, plaintiffs' attorneys are strongly motivated to accept assignments of defendants' rights when insurers deny coverage or otherwise fail to defend. Policyholders are typically happy to assign their rights to plaintiffs and to enter into consent judgments too, as long as

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60. *Id.* § 350 cmt. b.

61. For a thoughtful discussion of this subject, see James M. Fischer, *Does an Insured Have a Duty to Mitigate Damages When the Insurer Breaches?*, 20 CONN. INS. L.J. 89 (2013).

62. Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275 (2001).

63. *Id.* at 275–77.

64. Charles Silver et al., *Policy Limits, Payouts, and Blood Money: Medical Malpractice Settlements in the Shadow of Insurance*, 5 U.C. IRVINE L. REV. 559, 580–82 (2015); *see also* Baker, *supra* note 62, at 293.

plaintiffs agree to collect solely from their insurers. Post-assignment, plaintiffs' attorneys then do battle with the defendants' insurers over the existence of coverage and the reasonableness of the judgment amount. The practice of avoiding personal exposure by assigning rights is firmly established, the incentives supporting it are easily understood, and the law governing it is highly developed.[65] Assignments are expressly authorized in the Principles: "The insured may assign to the claimant . . . all or part of any cause of action for breach of the duty to defend the claim."[66] Although this provision is not repeated in section 25, we assume that the omission is inadvertent and that assignments are also permitted when insurers fail to reimburse defense costs on a timely basis while litigation is ongoing.

To verify that impecunious policyholders face little personal exposure when carriers fail to defend, we reviewed every case cited in the Reporters' Notes to sections 21 and 25 in support of or in opposition to the rule that insurers lose the right to contest coverage after breaching the duty to defend. Of the twenty-eight cases cited, seven involved liability defendants who were individuals not engaged in a business of some sort.[67] In two of these cases—*Gray v. Zurich Insurance Co.*[68] and *Liebovich v. Minnesota Insurance Co.*[69]—the individuals used personal funds to resolve the liability suit. Not surprisingly, both individuals were wealthy. The defendant in *Gray* was a doctor,[70] and the opinion in *Liebovich* described the policyholder as a "high net worth" individual whose coverage was specially designed for people of means.[71] Both defendants used their own money to defend themselves and paid moderate amounts for an affluent defendant—$6000[72] and $10,000,[73] respectively—to resolve the claims they faced.

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65. BARKER & KENT, *supra* note 57, § 4.07; Barker, *Selected Comments, supra* note 1, at 15–16.

66. PRINCIPLES OF THE LAW OF LIAB. INS. § 21(3) (AM. LAW INST., Tentative Draft No. 2, 2014).

67. *See* Flannery v. Allstate Ins. Co., 49 F. Supp. 2d 1223, 1224 (D. Colo. 1999); Lloyd v. State Farm Mut. Auto. Ins. Co., 860 P.2d 1300, 1301 (Ariz. Ct. App. 1992); Gray v. Zurich Ins. Co., 419 P.2d 168, 170 (Cal. 1966) (in bank); Farmers Union Mut. Ins. Co. v. Staples, 90 P.3d 381, 383 (Mont. 2004); Sanderson v. Ohio Edison Co., 635 N.E.2d 19, 21 (Ohio 1994); State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696, 697 (Tex. 1996); Liebovich v. Minn. Ins. Co., 728 N.W.2d 357, 360 (Wis. Ct. App. 2007).

68. 419 P.2d at 170.

69. 728 N.W.2d at 360.

70. *Gray*, 419 P.2d at 170.

71. *See Liebovich*, 728 N.W.2d at 360.

72. *Gray*, 419 P.2d at 170. The opinion does not give the date of the judgment against Dr. Gray. But assuming that it was in 1966 dollars, it would be equivalent to $44,063.89 in 2015 dollars. US INFLATION CALCULATOR, http://www.usinflation calculator.com/ (last visited Oct. 13, 2015).

The cases cited in the Reporters' Notes also bear out our assertion that policyholders often avoid personal or business exposure by assigning their rights against their insurers to plaintiffs. This tactic was used in eight cases.[74] In one of these, the defendant remained liable on the judgment, but the exposure seems to have been purely theoretical because the defendant, a small trucking company, had few assets.[75] When litigation in this matter ended, the insurance company satisfied the judgment and the policyholder paid nothing.[76]

Perhaps the best case for the Reporters is *Sauer v. Home Indemnity Co.*, in which the owner of a trailer park was sued by a number of mobile home owners whose properties were damaged when a sewer line froze.[77] After her insurer failed to provide a defense, the defendant used her own money to pay for one.[78] But she eventually suffered a default judgment when, in a bizarre twist that was never fully explained, the trial was rescheduled without proper notice to her after she left Alaska and moved to another state.[79] She then declared bankruptcy and sued her insurer.[80] Given *Sauer*'s strange procedural history, it is difficult to know what to make of the case. Normally, plaintiffs would rather take an assignment of a defendant's coverage rights than wind up entangled in a bankruptcy proceeding with a default judgment that might be worth little after creditors with superior claims are paid. We have no idea why the mobile home owners chose the course they did.

On the whole, then, the cases cited by the Reporters do not show that impecunious persons face significant financial exposure in liability suits when their carriers fail to defend. This should not be surprising, because such persons have few assets from which plaintiffs can collect. They are viable defendants only because they are conduits through which plaintiffs

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73. *Liebovich*, 728 N.W.2d at 360. The opinion does not give the date of the judgment against Liebovich. But assuming that it was in 2007 dollars, it would be equivalent to $11,475.97 in 2015 dollars. US INFLATION CALCULATOR, http://www.usinflationcalculator.com/ (last visited Oct. 13, 2015).

74. Lloyd v. State Farm Mut. Auto. Ins. Co., 860 P.2d 1300, 1302 (Ariz. Ct. App. 1992); Essex Ins. Co. v. Five Star Dye House, Inc., 137 P.3d 192, 193 (Cal. 2006); Xebec Dev. Partners, Ltd. v. Nat'l Union Fire Ins. Co. of Pittsburgh, 15 Cal. Rptr. 2d 726, 730 (Cal. Ct. App. 1993); Farmers Union Mut. Ins. Co. v. Staples, 90 P.3d 381, 384 (Mont. 2004); K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co., 6 N.E.3d 1117, 1119 (N.Y. 2014); Sanderson v. Ohio Edison Co., 635 N.E.2d 19, 22 (Ohio 1994); State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696, 698 (Tex. 1996); Emp'rs Cas. Co. v. Block, 744 S.W.2d 940, 942 (Tex. 1988).

75. *See Essex Ins. Co.*, 137 P.3d at 193.

76. *Id.*

77. 841 P.2d 176, 178 (Alaska 1992).

78. *Id.* at 179.

79. *Id.* at 179 n.5.

80. *Id.* at 180.

can reach their insurers. Once this is understood, it is obvious that plaintiffs have little interest in holding them personally responsible for losses. Because the real fight is usually between the plaintiff who receives the assignment and the defendant's insurer, the desire to protect defendants provides little basis for punishing insurers.

A further reason for questioning the propriety of the penalty provided for in section 25 relates to the fact that insurers sometimes sell stand-alone coverage for defense costs, that is, defense cost coverage that is not paired with coverage for liability costs. For example, the Medical Liability Mutual Insurance Company sells defense cost coverage for administrative proceedings and governmental investigations, but does not indemnify physicians for losses resulting from these proceedings. When employment practices liability insurance was first made available in the 1980s, it too covered only defense costs.[81] Employers had to bear the cost of unpaid wages, for example, on their own.

Obviously, when an insurer sells stand-alone coverage for defense costs, the penalty provided for in section 25 cannot be applied. There is no contract conferring coverage on the liability claim whose applicability the insurer may be estopped from denying. Unless the Reporters are willing to create liability coverage out of whole cloth, only the usual contractual remedies can be available in this context. True, one such remedy would be consequential damages, but to obtain it a policyholder would have to establish causation. A policyholder would also have a duty to make substitute arrangements for the defense of a claim. "[D]amages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation."[82] If a policyholder could have mounted a defense itself after its insurer failed to perform, compensation would not be available for losses attributable to its own failure to act.

The potential to sell coverage for defense costs independently from coverage for liabilities to third parties also raises a deeper question. Suppose it is admitted that, under a stand-alone policy covering only defense costs, the only remedy for breach would be consequential damages. Why should a different and more advantageous remedy be available when the identical misconduct occurs but the insurer happened to sell a policy in which coverage for defense costs and third party liabilities were paired? The existence of liability coverage would not make the carrier's failure to reimburse defense costs worse. And if, under the stand-alone policy, the ordinary contractual remedy would make the

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81. Joseph P. Monteleone, *Employment Practices Liability Insurance*, *in* ELLIS B. MUROV, THE PRACTITIONER'S GUIDE TO DEFENSE OF EPL CLAIMS 1 (2005).

82. RESTATEMENT (SECOND) OF CONTRACTS § 350(1) (AM. LAW INST. 1981).

insured whole, the additional remedy provided for in section 25 can only be excessive.

In sum, the remedy provided for in sections 21 and 25 for the failure to cover defense costs—loss of the right to contest coverage for the liability claim—is unwarranted. Legal remedies must be tailored to the rights that are infringed. When an insurer with a duty to cover defense costs on a timely basis fails to do so, the law should require it to restore a policyholder to its rightful position, i.e., the position the policyholder would have enjoyed had the insurer fully performed. This means that the policyholder must be indemnified for whatever costs it bore by handling the defense itself and for any consequential losses caused by the breach that could not readily be avoided.[83] Forfeiture of the right to contest coverage is not warranted because, had the insurer borne defense costs in a timely manner, it would have been free to challenge the existence of coverage and the policyholder would have borne the risk that the loss to the claimant was not insured.

IV. INSURERS SHOULD BE ALLOWED TO USE EXTRINSIC FACTS TO NEGATE THEIR DEFENSE-RELATED RESPONSIBILITIES

As explained in Part II, the Principles would require insurers to use extrinsic evidence—information that is or should be known to them but that is not pled in a complaint—inclusively, i.e., to create the potential for coverage that triggers their defense-related obligations. But, with two exceptions, the Principles would prohibit them from using the same information exclusively, that is, to extinguish the potential for coverage that is created by a complaint.

On the surface, the asymmetrical use of extrinsic evidence seems odd. If such information should be considered at all, it is only because it bears on the existence of insurance coverage for a claim. In other words, it can help insurers evaluate their contractual responsibilities more accurately. But it is Social Science 101 that mistakes come in two forms—false positives and false negatives—and that accuracy can be enhanced by reducing both. The gains in accuracy to be had by avoiding false positives are presumably great as well. Plaintiffs' attorneys understand the importance of pleading cases into coverage so as to get insurers involved in settlement negotiations by threatening them with defense costs.[84]

83. Consequential losses include judgments caused by the lack of proper defense and the amount of any inflation in judgments resulting from the lack of proper defense. BARKER & KENT, *supra* note 57, § 1.04[3].

84. *See* Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721, 1733–34 (1997).

False positives are therefore likely both to outnumber false negatives and to generate the lion's share of wrongly assigned defense costs.

The Principles' one-way approach is also jarring when compared to the prevailing practice in declaratory judgment actions brought to adjudicate the existence of coverage. In these proceedings, insurers can use extrinsic evidence to show that coverage did not exist.[85] The Reporters recognize this. "In the declaratory-judgment action, the insurer's continuing duty to defend is adjudicated on the basis of all the relevant facts and circumstances, without a presumption that the facts set forth in the complaint or comparable document that concern coverage are true."[86]

Why, then, do the rules stated in the Principles provide that extrinsic evidence should be used only to increase the number of occasions on which insurers' defense-related responsibilities will be triggered? Supposedly, the "widely accepted rule" endorses "a public policy of construing defense coverage broadly."[87] "The complaint-allegation rule and the one-way use of information beyond the complaint are two of the most important ways in which the duty to defend is broader than the duty to indemnify."[88] However, "widely accepted" does not mean universal; there is another rule. As a comment notes:

> Some jurisdictions . . . use a different, all-the-facts-and-circumstances approach to determining whether a claim gives rise to a duty on the part of the insurer to defend the case. Under this all-the-facts-and-circumstances approach, the insurer[,] in deciding whether to provide a defense of a claim[,] may take into account any and all circumstances that bear on whether the claim is covered.[89]

Given the split of authority, there should be a reason why the one chosen is the better rule.

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85. *See* PRINCIPLES OF THE LAW OF LIAB. INS. § 20 cmt. j (AM. LAW INST., Tentative Draft No. 2, 2014).

86. *Id.*

87. *Id.* § 15 cmt. c. While the rule stated is indeed "widely accepted," there is considerable variation among jurisdictions on the extent to which extrinsic facts can be used exclusively. BARKER & KENT, *supra* note 57, § 3.02[4][b].

88. PRINCIPLES OF THE LAW OF LIAB. INS. § 15 cmt. c (AM. LAW INST., Tentative Draft No. 2, 2014).

89. *Id.* § 15 cmt. f.

The explanation offered is that the all-the-facts-and-circumstances approach creates uncertainty for the insured.[90] When an insurer relies on extrinsic evidence as a basis for declining to defend,

> [t]he possibility of bringing a subsequent case against the insurer for breach of the duty to defend will be of little comfort to insureds, who will find such litigation expensive and daunting. By contrast, under the [approach taken by the Principles,] there is substantially less uncertainty borne by insureds regarding when they can expect to receive a defense from their liability insurer. So long as the complaint contains allegations that if proven true would be covered, or the insured can offer evidence outside of the complaint that supports coverage, the insured can be confident of receiving a defense.[91]

The logic of this passage is unassailable. Any approach that increases the number of occasions on which carriers must defend will give policyholders greater confidence of receiving a paid defense. But if the object is to maximize policyholders' confidence, why stop there? Why not require insurers to defend whenever policyholders want them to, whether or not a potential for coverage exists? Although the question may seem facetious, no analytical (as opposed to doctrinal) answer to it is provided by the Principles. The reason offered for adopting the one-way approach has no natural stopping point short of requiring carriers to defend all claims.

Moreover, that reason erroneously assumes that the insured would necessarily be the one to sue the insurer. As previously explained, where the insured is relatively impecunious (as most insureds covered by personal lines policies are), denial of a defense will likely result in a settlement or default judgment, coupled with a covenant not to execute and a suit against the insurer by the claimant.[92] Only insureds with sufficient assets to make a payment large enough to be worth the cost of pursuing it would find it necessary to defend and litigate with the insurer.[93] Those are precisely the insureds who would find it least "daunting" to engage in such litigation. Yet, those are the only insureds who have any need for the protection provided by the rule against use of extrinsic facts to deny a defense.

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90. *Id.*
91. *Id.*
92. *See* Barker, *Selected Comments*, *supra* note 1, at 15–16.
93. *See id.* at 16.

Nor does the reason offered for the rule account for the two exceptions to the one-way approach the Principles endorse in section 15. In what seems like a surprise move given the rest of this section, section 15(3) allows insurers to use the "all-the-facts-and-circumstances" approach when deciding whether a person or entity is insured and whether the events on which the liability is said to be based occurred within the time period covered by the policy.[94] No analytical justification is offered for these exceptions.[95] Instead, it is argued that "[c]ourts and commentators . . . have struggled unsuccessfully to identify a general standard that can be used reliably to identify those claims for which an all-the-facts-and-circumstances standard . . . should be applied."[96] We submit that the claim of an unsuccessful struggle is incorrect. Courts and commentators have defined a logical and workable rule allowing consideration of facts that bear on coverage but are not at issue in determining the insured's alleged liability.[97] We think that rule is correct. If that rule is to be rejected, it must be confronted, not ignored.

V. SOME OF THE RULES STATED BY THE PRINCIPLES REGARDING CONDUCT OF THE DEFENSE ARE QUESTIONABLE

Sections 13 and 16 of the Principles state rules governing the conduct of the defense that we think are ill-founded and (in the case of section 13) unworkable. Under section 16, violation of those rules would breach the duty to defend, thereby triggering a forfeiture of coverage defenses under section 21(1).[98] For reasons previously stated, we would oppose the forfeiture even if we agreed there had been a breach.[99] But, in this

94. PRINCIPLES OF THE LAW OF LIAB. INS. § 15(3) (AM. LAW INST., Tentative Draft No. 2, 2014).

95. The exception for determining whether the person demanding a defense is an insured can be justified analytically, because the duty to defend is based on a promise, and a person who is not an insured is not a promissee or beneficiary. *See* BARKER & KENT, *supra* note 57, at § 3.02[4][b][ii]. But such contractual logic is eschewed by the Principles, perhaps because it would tend to undercut the basic rule provided in section 15.

96. PRINCIPLES OF THE LAW OF LIAB. INS. § 15 cmt. g (AM. LAW INST., Tentative Draft No. 2, 2014).

97. *See* Barker, *Selected Comments*, *supra* note 1, at 3-13.

98. PRINCIPLES OF THE LAW OF LIAB. INS. §§ 16(1), 21(1) (AM. LAW INST., Tentative Draft No. 2, 2014).

99. *See supra* Part III. We have no quarrel with the rule of holding an insurer vicariously liable for errors by defense counsel it directs. PRINCIPLES OF THE LAW OF LIAB. INS. § 14 (AM. LAW INST., Tentative Draft No. 2, 2014). We also assume that an insurer would be liable for any negligence or fault in its management of the defense. But such liability would be only for damage caused, rather than forfeiting coverage defenses.

discussion, we examine the substantive rules we question, starting with section 16.

A. Section 16 Should Not Expand the Duty to Defend to Protect Uninsured Interests

The duty to defend requires more than just payment; an insurer with a duty to defend must deliver services as well. These services are described in section 16 of the Principles, which requires a carrier to provide a defense that meets professional standards, is reasonably calculated to protect the insured from all risks posed by the liability suit (including risks that fall outside the scope of insurance coverage), and keeps confidential from the insurer information that could be used to the detriment of the insured.[100]

Confidentiality will be addressed in part V.B. Our focus here is on the requirement to "[m]ake[] reasonable efforts to protect the insured from all of the risks posed by the claim, including risks not covered by the liability insurance policy."[101]

In some respects, this requirement is perfectly conventional. The insurance contract requires defense of suits asserting claims that, if established, would be covered. But the Principles require defense of the entire suit, including any non-covered claims that may be asserted.[102] Clearly, that requires that the non-covered claims be properly defended. Insofar as the suit asserts non-covered claims or claims in excess of limits, the rule stated by the Principles is that "reasonable efforts means those efforts that a reasonable insurer that faced the full judgment risk would take to defend the claim."[103] While we are aware of no authority that has made this point, it is an eminently sensible reading of the contract, analogous to the disregard-the-limits rule commonly applied in the context of the duty to make reasonable settlement decisions.[104]

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100. PRINCIPLES OF THE LAW OF LIAB. INS. § 16(1) (AM. LAW INST., Tentative Draft No. 2, 2014).

101. *Id.* § 16(1)(b). Because this provision speaks in terms of "protect[ing]" insureds from "risks," we infer that an insurer need not help a policyholder achieve goals that require larger payments to claimants. For example, in a suit between spouses, the policyholder may want the plaintiff to recover as much money as possible because the insurer will provide the money. We do not read section 16 as requiring an insurer to run the defense in a manner calculated to help a policyholder achieve this objective. To avoid uncertainty, we urge the Reporters to add a clarifying comment to this effect.

102. *See id.*

103. *Id.* § 16 cmt. b.

104. *See* BARKER & KENT, *supra* note 57, § 2.03[2][d] (describing the rule, originated by Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954)).

However, the Comment on this provision states that the phrase "risks not covered by the liability insurance policy" includes "consequences of [a] claim that are not insured, such as damage to goodwill or reputation."[105] The current document does not specify what sort of "reasonable efforts" an insurer must make to protect a policyholder from such consequences. It says that the requirement to consider "consequences of the claim that are not insured" follows from an insurer's duty of good faith and fair dealing, which is to be addressed in a chapter of the Principles that is not yet written.[106]

While recognizing the danger of criticizing the Reporters prematurely, it seems fair to observe that this is not an auspicious beginning. The reason is simple. The purpose of the duty of good faith and fair dealing is to ensure that parties enjoy the benefits of the bargains they strike, not to add benefits beyond those that were agreed to and paid for. As the Restatement (Second) of Contracts states, "[g]ood faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party."[107] The "agreed common purpose" of a liability insurance contract is that the insurer will minimize the cost of responding to covered claims, and the policyholder's "justified expectation" is that the insurer will do exactly that. Uninsured consequences must fall outside the agreed common purpose of the insurance bargain precisely because they are not insured.

It is well established that an insurer need not settle to protect a policyholder's reputation or business goodwill, because protection of those interests is not within the coverage of standard policies.[108] That is, under a standard liability policy, an insurer must cover the cost of a judgment or a settlement but need not compensate an insured for reputational damage or loss of goodwill caused by a lawsuit. Consequently, when defending a lawsuit an insurer has a strong incentive to minimize the judgment risk associated with a liability claim, but it has little direct interest in avoiding damage to a policyholder's reputation or protecting a policyholder's goodwill. Worse, the actions required to protect these uninsured losses may be the exact opposite of those that are likely to minimize the covered loss. Consider a case in which the plaintiff claims to have suffered a sexual assault while on the policyholder's premises. Minimizing the judgment risk on the liability claim may require a

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105. PRINCIPLES OF THE LAW OF LIAB. INS. § 16(1)(b) & § 16 cmt. b (AM. LAW INST., Tentative Draft No. 2, 2014).

106. *Id.* § 16 cmt. b.

107. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (AM. LAW INST. 1981).

108. *See* Barker, *Selected Comments*, *supra* note 1, at 46–49.

scorched-earth defense. But a scorched-earth defense may maximize the policyholder's reputational loss by generating media interest in the case, delaying settlement, seeming to punish the victim, etc.

The requirement to take uninsured collateral consequences into account when defending claims appears to strike at the heart of the bargain between policyholders and insurers. The bargain transfers identified risks to insurers and leaves policyholders with the rest. The failure to transfer the residual risks may have many explanations, but for present purposes the reasons do not matter. What matters is that the rules stated by the Principles governing the duty to defend would expressly require insurers to address risks that were excluded from the insurance deal. How can rules that rewrite insurance bargains be defended?

Of course, it may yet be possible for the Reporters to develop and justify some limited qualifications based on the duty of good faith, in which case the criticism here might be mooted. On the other hand, many of the rules already included in the Principles appear designed to stretch (or at least have the effect of stretching) the coverage provided by applicable policies,[109] and that suggests that the rules promised for the future might do more of the same. We hope that will not occur.

B. *The Special Confidentiality Rule Provided by Section 13 Overreaches Any Justification and Appears Unworkable in Practice*[110]

Two insurance-law rules on confidentiality are stated in the Principles. The first rule, found in section 13, addresses what information the carrier is entitled to receive from the policyholder or defense counsel. "A liability insurer does not have the right to receive any . . . information [protected by attorney-client privilege, work product immunity, or other confidentiality protections] of the insured if that information could be used to advantage the insurer at the expense of the insured."[111]

This rule is elaborated as follows:

> The principle stated . . . is a principle of liability insurance law that is complementary to the rules stated in the Restatement Third of the Law Governing Lawyers, which expressly decline to address the law governing the relationship between insurer and

109. *See infra* Part VI; *see also* Barker, *Selected Comments*, *supra* note 1, at 2.

110. This section contains material adapted, with permission, from BARKER & SILVER, *supra* note 4, § 2.06.

111. PRINCIPLES OF THE LAW OF LIAB. INS. § 13(2) (AM. LAW INST., Tentative Draft No. 2, 2014).

> insured. Rules governing lawyers' professional obligations are outside the scope of this Project. Under the principle stated[,] . . . the insurer's right to defend does not include the right to receive confidential information from the defense lawyer that could disadvantage the insured with regard to a matter that is in dispute, or potentially in dispute, between the insurer and the insured. This principle reduces the . . . concern that an insurer c[ould] use its control over the defense to further its own interests at the expense of the insured.[112]

Two illustrations make it clear that the phrase "confidential information of the insured" applies only to information conveyed to the lawyer retained to defend the liability suit.[113] In the first illustration, the defense lawyer meets privately with a child who started a fire at a school and with the child's parents.[114] The lawyer learns "that the child may have intentionally set the fire for the purpose of damaging the school."[115] The illustration then states that the insurer has no right to the information because it might "refuse to pay the claim based on an exclusion for intentional harm in the liability insurance policy and because the information is protected by attorney-client privilege."[116] In the very next illustration, however, the child reveals the same information in a deposition.[117] "[E]ven though the testimony could lead the insurer to refuse to pay the claim," the insurer is entitled to the information "because deposition testimony is not confidential."[118]

As these illustrations demonstrate, information can be both coverage-related and defense-related at the same time. Intentional injuries are not covered. But intentional setting of the fire also bears on defense because it poses a risk of enhanced liability, perhaps including punitive damages, and could nullify defenses that might be available on a negligence claim. Because the information bears on the defense, the insurer needs it to evaluate the claim for defensive purposes and to figure out how much to pay in settlement. The insurer is also presumptively entitled to the information because homeowners' policies typically require an insured to cooperate in the defense and to give a sworn statement at an insurer's request. To our knowledge, no standard liability insurance form contains

112. *Id.* § 13 cmt. C (citations omitted).
113. *Id.* § 13 cmt. c, illus. 3 & illus. 4.
114. *Id.* § 13 cmt. c, illus. 3.
115. *Id.*
116. *Id.*
117. *Id.* § 13 cmt. c., illus. 4.
118. *Id.*

any provision that would entitle an insured to withhold defense-related information from an insurer.

Turning to the second special confidentiality rule, section 16(1)(c) states that the duty to defend "includes the obligation to provide a defense of the claim that . . . [p]rotects from disclosure to the insurer any confidential information of the insured that could be used to advantage the insurer at the expense of the insured."[119] A comment states "that the insurer's duty to defend includes the obligation to arrange the defense so that the lawyer retained by the insurer does not have an obligation to the insurer to reveal such confidential information, directly or indirectly, including through withdrawal from the representation of the insured."[120] This seems to say that an insurer must retain a defense lawyer on terms that permit or even require the lawyer to keep secrets, without telling the insurer that information is being withheld and without withdrawing.

The section 13 rule that the duty to cooperate does not override any confidentiality protections for communications of the policyholder with defense counsel is well established in contexts where the insured was defended by independent counsel. Because independent counsel represents only the policyholder, communications between the two are ordinarily protected from disclosure and discovery, meaning that the insurer may not obtain access to them for the purpose of contesting coverage. While Illinois disagrees on this point,[121] the Illinois rule has been almost universally rejected.[122] In particular, a California statute

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119. *Id.* § 16(1)(c).

120. *Id.* § 16 cmt. e.

121. Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co., 579 N.E.2d 322, 328 (Ill. 1991) ("[T]he cooperation clause imposes a broad duty of cooperation and is without limitation or qualification. It represents the contractual obligations imposed upon and accepted by insureds at the time they entered into the agreement with insurers. In light of the plain language of the cooperation clause in particular, and language in the policy as a whole, it cannot seriously be contended that insureds would not be required to disclose contents of any communications they had with defense counsel representing them on a claim for which insurers had the ultimate duty to satisfy. . . . Insureds' duty to cooperate . . . did not end with the termination of the underlying lawsuit . . . . The fact that the parties are now adverse concerning the interpretation of [the terms of the policy] does not negate insureds' contractual duty. A fair reading of the terms of the contract renders any expectation of attorney-client privilege, under these circumstances, unreasonable. We conclude that the element of confidentiality is wanting and, therefore, the attorney-client privilege does not apply to bar discovery of the communications in the underlying lawsuits.").

122. *E.g.*, Remington Arms Co. v. Liberty Mut. Ins. Co., 142 F.R.D. 408, 418 (D. Del. 1992) ("[T]he rationale which supports the 'common interest' exception to the attorney-client privilege simply doesn't apply if the attorney never represented the party seeking the allegedly privileged materials." (quoting Bituminous Cas. Corp. v. Tonka Corp., 140 F.R.D. 381, 387 (D. Minn. 1992))); E. Air Lines, Inc. v. U.S. Aviation Underwriters, Inc., 716 So. 2d 340, 343 (Fla. Dist. Ct. App. 1998) ("Under Florida law, the cooperation clause does not eviscerate the attorney-client privilege."); *see also* BARKER & SILVER, *supra* note 4, §

provides that independent counsel and the insured have a duty "to disclose to the insurer all information concerning the action *except privileged materials relevant to coverage disputes* . . . . Any claim of privilege asserted is subject to in camera review in the . . . superior court."[123]

Extension of that rule to cases in which the policyholder is represented by insurer-directed counsel is consistent, as a practical matter, with the confidentiality protections that would otherwise apply to the policyholder's own disclosures to counsel even in the context of a joint representation.[124] But it would abrogate the usual rule that there is no privilege as between co-clients. Moreover, if combined with section 16(1)(c), the withholding of information from the carrier would no longer be signaled by withdrawal.

If meant to be applied to ordinary situations, in which defense counsel represents both the carrier and the insured, the principles stated in section 13 and section 16 face serious difficulties. The first is the lack of any foundation in the terms of standard liability insurance policies upon which the principles may be said to rest. Typical policies include blanket language requiring policyholders to cooperate in the investigation, defense, and settlement of the suit. Nothing in this language suggests any limitation on a carrier's right to relevant information of any type. Neither privileged information, confidential information, nor information that might conceivably be used to the detriment of the policyholder is mentioned. Consequently, it seems impossible to find a *contractual basis* for limiting carriers' access to this information, and nothing stated in the Principles explains why insurance law ought to impose this special confidentiality rule.

Where, as in most jurisdictions, the insurer and the policyholder are regarded as co-clients,[125] the normal rule calls for open communication within the joint attorney-client relationship of all information relevant to

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14.04[3][c].

123. CAL. CIV. CODE § 2860(d) (West 2012) (emphasis added); *accord* Rockwell Int'l Corp. v. Superior Court, 32 Cal. Rptr. 2d 153, 158 (Cal. Ct. App. 1994) (explaining that where a conflict exists, "the insured is entitled to independent counsel and to a relationship with that counsel free from the fear of disclosure of privileged communications" and collecting cases rejecting Illinois rule).

124. *See* BARKER & SILVER, *supra* note 4, § 10.04.

125. *Id.* § 4.04[2]; *see also* MODEL RULES OF PROF'L CONDUCT rr. 1.4, 1.7 cmt. 31 (AM. BAR ASS'N 2014) ("As to the duty of confidentiality, continued common representation will almost certainly be inadequate if one client asks the lawyer not to disclose to the other client information relevant to the common representation. This is so because the lawyer has an equal duty of loyalty to each client, and *each client has the right to be informed of anything bearing on the representation that might affect that client's interests and the right to expect that the lawyer will use that information to that client's benefit*." (emphasis added)).

the defense of liability claims.[126] Where disclosure of the policyholder's confidential information to the insurer would be detrimental to the policyholder, counsel would normally be precluded from making such disclosure without the policyholder's informed consent, but inability to make such disclosure would require counsel to withdraw from representing the insurer.[127]

Section 16 stands these rules on their heads. It requires a defense lawyer to keep relevant information secret for the benefit of an insured. This implicitly negates the policyholder's presumptive "fiduciary duty to share all information material to the co-clients' joint enterprise,"[128] and it expressly overrules the lawyer's duty to keep the carrier properly informed.

The obvious assumption upon which section 16 rests is that the Restatement (Third) of the Law Governing Lawyers ("Law Governing Lawyers") permits insurers to change the normal baseline rules when engaging defense lawyers. In fact, the baseline rules can be altered, but not to the degree required by section 16. As the Law Governing Lawyers explains:

> Even if the co-clients have agreed that the lawyer will keep certain categories of information confidential from one or more other co-clients, in some circumstances it might be evident to the lawyer that the uninformed co-client would not have agreed to nondisclosure had that co-client been aware of the nature of the adverse information. . . . In view of the co-client's agreement, the lawyer must honor the commitment of confidentiality and not inform the other client . . . . The lawyer must, however, withdraw if failure to reveal would mislead the affected client, involve the lawyer in assisting the communicating client in a course of fraud, breach of fiduciary duty, or other unlawful activity, or, as would

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126. *See* BARKER & SILVER, *supra* note 4, § 10.02; *see also* RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. *l* (AM. LAW INST. 2000) ("[T]he common lawyer is required to keep each of the co-clients informed of all information reasonably necessary for the co-client to make decisions in connection with the matter. The lawyer's duty extends to communicating information to other co-clients that is adverse to a co-client, whether learned from the lawyer's own investigation or learned in confidence from that co-client." (citation omitted)); 1 GEOFFREY C. HAZARD, JR., W. WILLIAM HODES & PETER R. JARVIS, THE LAW OF LAWYERING § 10.13 (4th ed. 2015) ("[As between co-clients,] [t]he default rule . . . is that there is no confidentiality, because b[y] definition all clients are confiding in the same lawyer or lawyers . . . .").

127. *See* BARKER & SILVER, *supra* note 4, § 10.04.

128. RESTATEMENT (THIRD) OF THE LAW GOVERNING LAWYERS § 60 cmt. *l* (AM. LAW INST. 2000).

> be true in most such instances, involve the lawyer in representing conflicting interests.[129]

A defense lawyer's failure to communicate defense-related information potentially prejudicial to an insured could implicate all of these concerns, and would certainly involve the lawyer in a conflict.

Nor would it be enough to say that the duty to defend requires an insurer to waive any conflict. Under the Law Governing Lawyers, lawyers can accept conflict waivers only when clients are fully informed.[130] But in this context, a waiver cannot possibly be informed because section 16 prohibits an insurer from receiving any information that would clue it into the nature of the information that is being withheld. The Law Governing Lawyers would therefore require a defense lawyer to withdraw. But under section 16, withdrawal is prohibited.[131] We therefore conclude that section 16 demands the impossible.

Even if one accepted the general appropriateness of the rule, it would still be problematic in some of its applications. Consider the hypothetical in which the defense lawyer learns in a private conversation with the child and the parents that the child set the fire intentionally.[132] If the defense lawyer *knows* that the carrier could use this information as a basis for denying coverage, then the duty to refrain from acting to a client's detriment might preclude disclosure to the insurer.

But what if the defense lawyer is ignorant? In other writings, we explain that a defense lawyer has no duty to know coverage law,[133] and nothing in the Principles says that the carrier must provide a lawyer who knows coverage law or conditions the proposed duty to withhold information from the carrier on the lawyer having this expertise. Although a typical defense lawyer would probably recognize the coverage-related implications of the information conveyed in the particular example used in the Principles, it would be unreasonable to expect defense lawyers to recognize coverage issues that are less common and more complex.[134]

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129. *Id.*

130. *Id.* § 122(1) & § 122 cmts. c(i)-(ii); *see also* MODEL RULES OF PROF'L CONDUCT r. 1.7(b)(2) (AM. BAR ASS'N 2013).

131. *See* PRINCIPLES OF THE LAW OF LIAB. INS. § 16 cmt. e (AM. LAW INST., Tentative Draft No. 2, 2014).

132. *Id.* § 13 cmt. c., illus. 3.

133. *See* BARKER & SILVER, *supra* note 4, § 8.04[6].

134. Had such a defense involving facts overlapping with the underlying liability claim been asserted, the insured would have been entitled to independent counsel and the issue of insurer-directed defense counsel's duties would never have arisen. *Id.* § 6.04. If the defense was not asserted, insurer-directed counsel might not recognize that the relevant facts could

A slight tweak emphasizes the seriousness of this difficulty. Suppose that the information acquired by the lawyer relates to a previous fire set by the child, rather than the fire at issue in the liability action. Suppose further that the parents failed to disclose the prior fire when applying for insurance, and that disclosure may cause the carrier to withdraw on the basis of fraud or misrepresentation in the insurance application. Do the principles set out in section 13 and section 16 require defense lawyers to know what policyholders said when applying for coverage? If so, then the Principles again require the impossible because defense lawyers never have this information.

It is also unclear how the Principles would treat information detrimental to the policyholder's coverage interests received from an independent third party[135] outside the discovery process. Such information is not privileged, but the lawyer is obliged to keep it confidential from those not parties to the representation.[136] If the carrier is a co-client with the insured, such information is part of its own representation and not confidential from it.[137] But the focus of the special rules proposed by the Principles seems to be on preventing the carrier from gaining informal access to information *from the policyholder* that the carrier would not have in the absence of joint representation, so the special rules might be limited to such information. If so, that should be clarified.

The rule of section 16(c) would only have significance where the coverage issue had been latent. If the carrier had identified a coverage issue overlapping with the issues in the suit against the policyholder and reserved its rights on that issue, the policyholder should have been given independent counsel.[138] If the coverage issue had been obvious from the facts known to the carrier and it had not reserved rights, the coverage issue would presumably have ceased to be a viable defense to the duty to indemnify.[139] The fact pattern to which the rule would apply is modeled on *Parsons v. Continental National American Group*[140] and is infrequent, in part because most carriers reserve rights wherever they see a possibility of non-coverage (even though they do not yet have any factual support for contesting coverage). It is even less likely now that

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create a defense.

135. For purposes of this discussion, information obtainable only with the policyholder's consent (e.g., medical records) is treated as coming from the policyholder, not from the third party who actually supplies it.

136. BARKER & SILVER, *supra* note 4, § 10.01.

137. *See id.* § 10.04[3][b].

138. *Id.* § 6.03.

139. *Id.*

140. 550 P.2d 94, 98–99 (Ariz. 1976) (in banc).

policyholders have a well-established and robust right to independent counsel in case of conflict.

The principal effect of the rule, if adopted, would be to prevent counsel from alerting the carrier to a latent issue by withdrawing. But even if the rule were adopted, it would provide little benefit to policyholders, because defense counsel's interactions with the carrier would be altered in ways likely to alert the carrier despite the failure to withdraw. Take the facts assumed in illustration 3, where the interview with the insured child and his parent reveals that the child may have set a fire for the purpose of burning the school.[141] The adjuster, in preparing to evaluate the case and to review a plan to defend it, would surely ask, "What is the kid's story?" Counsel could neither disclose the story nor misrepresent it, so counsel would have to reply, "I can't tell you." At that point, the adjuster would be at least as alerted as would have been the case had defense counsel withdrawn. Similarly, counsel would, sooner or later, be asked to evaluate the case. An evaluation reflecting the information withheld from the insurer would violate the requirement to refrain from disclosing, while an evaluation ignoring that information would be a misrepresentation. So, counsel would need to refuse to evaluate. And, of course, the policyholder would need to testify (at deposition or trial) unless the case settled first, and that testimony (or assertion of the privilege against self-incrimination) would alert the adjuster.

Thus, the only real benefit to the policyholder of allowing defense counsel to continue instead of withdrawing would be the possibility that the carrier might settle the case before normal interactions with defense counsel disclosed the existence of a coverage problem. That would be unlikely, because counsel would likely be asked for an evaluation before any settlement, and would necessarily refuse to evaluate. But it might happen that a settlement might be made on the basis of an evaluation given before counsel learned the facts that cannot be disclosed.

Nor is it clear that such a benefit is one that insurance purchasers, if asked at the time they purchased and were informed of the costs and benefits, would want to pay for. Many will see little or no chance that they will face non-covered risks of a sort that could make the rule of section 16(1)(c) applicable. To be sure, the cost would be small because the situation is so uncommon. But the benefit could fairly be characterized as tiny, even in cases where that rule applies. And, if one

141. PRINCIPLES OF THE LAW OF LIAB. INS. § 13 cmt. c, illus. 3 (AM. LAW INST., Tentative Draft No. 2, 2014).

sees little prospect of facing such a situation, one would not want to pay the cost of conferring the benefit on those who do.

In sum, the proposed rule of section 16(1)(c) seems ill-advised, though its negative effects would be limited by the infrequency of its application.

VI. THESE AND OTHER PROVISIONS OF THE PRINCIPLES WOULD IMPROPERLY STRETCH THE COVERAGE OF LIABILITY INSURANCE POLICIES

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.

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.

When underwriting and pricing coverage, insurers can safely ignore aspects of an applicant's risk profile that relate to uncovered activities because applicants are expected to bear the costs of these activities themselves or to insure them under other policies.

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 Principles not discussed in this Article have similar effects.[142]

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 Principles 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 Principles 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 Principles 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 Principles.

No attempt is made in the Principles 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 Principles have not been adequately justified and ought not to be adopted by lawmakers.

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142. *See* Barker, *Selected Comments*, *supra* note 1, at 1–13.

VII. CONCLUSION

Our examination of the sections in the Principles that relate to insurers' defense-related rights and responsibilities has turned up a number of deficiencies. Sections 21 and 25 impose a penalty for breach of the duty to defend that is excessive as a matter of contract law, frees policyholders from the duty to avoid losses when they reasonably can, and is unsupported by empirical evidence regarding the dangers policyholders incur. Section 15 rightly endorses the use of extrinsic facts to trigger the duty to defend but wrongly prohibits the use of the same class of information to negate that duty. Sections 13 and 16 require ground rules for the conduct of defensive representations that have no basis in insurance contracts, that subject defense lawyers to unwarranted burdens (including burdens that may be impossible to meet), and that conflict with the Law Governing Lawyers, which sets out rules for attorneys, including attorneys hired by liability insurers to defend lawsuits against insureds.

These are serious problems, not minor ones. Some of them go to the heart of insurance bargains. They arise because the rules proposed in the Principles would rewrite those bargains by conferring benefits and imposing burdens the parties neither agreed to nor, heretofore, took into account when pricing coverage. Others arise because the rules proposed in the Principles would throw sand in the gears of defensive representations. We know of no evidence that defensive representations are working poorly at present or are in need of a major overhaul. To the contrary, the studies of which we are aware suggest that defensive representations normally function smoothly. Insurers manage them in ways that minimize total costs without exposing policyholders to significant uninsured losses. Given this, we urge the Reporters to take as their maxim the Latin phrase "*primum non nocere*"—"first, do no harm."

We urge that, when converting the Principles to a Restatement, provisions forcing or pressuring insurers to incur costs to protect policyholders against non-covered risks be reconsidered and dropped, unless persuasive justifications can be offered for them.