

The Draft Restatement Improperly Limits Use of Extrinsic Evidence in Insurer Decision-Making on Duty To Defend

By William T. Barker¹

The thesis of this article is that a liability insurer, in determining whether it has a duty to defend a suit against one claiming to be an insured should be entitled to consider any evidence extrinsic to the complaint against the insured that bears on facts not at issue in the suit it has been called upon to defend; in certain circumstances, it may even be entitled to consider evidence bearing on facts that are at issue in that suit. That issue is now in dispute in the process of drafting a "Restatement of the Law of Liability Insurance." This article will describe the dispute and criticize both of the competing drafts.²

The American Law Institute ("ALI") is now drafting this Restatement. Most of Chapters 1-3 has now been approved by the ALI Council and the ALI Annual Meeting, and therefore

¹William 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 commercial 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 Prof. Charles Silver) of *PROFESSIONAL RESPONSIBILITIES OF INSURANCE DEFENSE COUNSEL*. He is an Adviser to the American Law Institute project on Restatement 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.

²This article contains material adapted from William T. Barker & John Buchanan, III, *The American Law Institute Principles of the Law of Liability Insurance: Part I--What Rules Does It State?*, in *NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW* (Winter 2014); 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* (Spring 2015); William T. Barker, *When Can Extrinsic Evidence Defeat the Duty To Defend*, *NEW APPLEMAN ON INSURANCE: CURRENT CRITICAL ISSUES IN INSURANCE LAW* 1 (April 2007); WILLIAM T. BARKER & RONALD D. KENT, *NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION*, and from the forthcoming Chapter 16A of *NEW APPLEMAN ON INSURANCE LAW, LIBRARY EDITION*. Copyright 2016 Matthew Bender & Company, Inc., a LexisNexis company. All rights reserved. The Principles project was converted to a Restatement project, but much of the Restatement is based on the Principles previously approved.

represents the policy of the ALI. However, one provision, regarding use of evidence extrinsic to the complaint against the insured remains unsettled. Nothing is the policy of the ALI unless approved by both the Council and the Annual Meeting, which function like a bicameral legislature. The Council approved one version, but the Annual Meeting amended it. Unless and until the two agree, the relevant provision is still a draft, not yet part of the Restatement.

I. Background: What Is a Restatement

Restatements are intended to be "clear formulations of common law and its statutory elements or variations and reflect the law as it presently stands or might plausibly be stated by a court."³ Even so, Restatements need not reflect the majority rule:

A Restatement ... assumes the perspective of a common-law court, attentive to and respectful of precedent, but not bound by precedent that is inappropriate or inconsistent with the law as a whole. Faced with such precedent, an Institute Reporter is not bound to adhere to ... "a preponderating balance of authority" but is instead expected to choose the better rule and provide the rationale for choosing it. A significant contribution of the Restatements has also been anticipation of the direction in which the law is tending and expression of that development in a manner consistent with previously established principles.⁴

For each ALI project, the ALI Council appoints distinguished Reporters, who draft the proposed text. The Reporters for the Restatement are Professors Tom Baker and Kyle Logue. The ALI also appoints Advisors. The Advisors to this project include both insurer and policyholder counsel, law professors, judges, as well as others who fit none of those descriptions. Any member of the ALI who wishes to do so may join the project's Members Consultative Group ("MCG").

In accordance with the ALI's normal process, each portion of the Restatement begins as a Preliminary Draft, prepared by the Reporters and circulated to the Advisors and the MCG. (For

³American Law Institute, *Capturing the Voice of the American Law Institute*, at 4 (2005).

⁴American Law Institute, *Capturing the Voice of the American Law Institute*, at 5 (2005).

this Restatement, chapters 1 and 2 began in a similar way as Principles, but were reconsidered de novo as a Restatement.) The Advisers and the MCG meet with the Reporters to comment on the Preliminary Draft and may submit written comments. (In fact, anyone who learns what a draft says can submit written comments.) The Reporters consider the comments. Sometimes they produce and circulate a new Preliminary Draft, but they usually revise the Preliminary Draft to produce a Council Draft for submission to the ALI Council.

The Council may amend what the Reporters submit or direct them to revise it in a particular way. The Council may submit to the Annual Meeting of the ALI members either a Discussion Draft or a Tentative Draft. Nothing becomes the policy of the ALI unless approved by both the Council and the Annual Meeting, so a Tentative Draft is subject to amendment by the Annual Meeting. If a section is amended at the Annual Meeting, that section must be referred back to the Council.

Unless an amendment is adopted, the membership at the Annual Meeting typically approves whatever the meeting has discussed, subject to customary privileges of the Reporters to perfect the draft in light of the discussion. At the end of a project, revised versions of material previously approved in Tentative Drafts (possibly with other material) may be presented for approval as Proposed Final draft, still subject to customary privileges of the Reporters to perfect the draft in light of the discussion.

Each section of a draft is composed of a "black letter" statement of a governing rule, followed by "comments" and "illustrations" explaining the rule and the reasoning supporting it and elaborating on its application. Both the black letter and the comments/illustrations speak for the ALI. Each section is accompanied by a Reporters' Note, discussing the authority supporting and (where it exists) opposing the rules stated in the black letter and comments; the Reporters' Note speaks only for the Reporters.

II. The Restatement and Extrinsic Evidence

The Restatement reflects conventional doctrine on the breadth of the duty to defend: "An insurer that has issued a liability insurance policy that includes a duty to defend must defend any legal action brought against an insured that is based in whole or part on any allegations that, if proven, would be covered by the policy, without regard to the merits of those allegations."⁵

Courts in different jurisdictions take a variety of views on the use of extrinsic evidence in determining the duty to defend.⁶ Under the Restatement, a defense must be provided, not only when a potentially covered claim appears from the face of the complaint, but also when such a claim appears based on "[a]ny additional allegation, not contained in the complaint or comparable document stating the legal action, that a reasonable insurer would regard as an actual or potential basis for all or part of the action."⁷ In contrast to this use of extrinsic evidence to trigger a duty to defend, the Restatement clearly states that

[t]he general rule is that insurers may not use facts outside the complaint as a basis for refusing to defend, with the result that even an insurer with a strong factual basis for contesting coverage must defend under a reservation of rights and then file a declaratory-judgment action in order to avoid a duty to defend.⁸

The precise scope of the exceptions to this rule is unsettled, because the relevant section of the Restatement was amended at the Annual Meeting. The amendment has not yet been submitted to the ALI Council, so neither the Tentative Draft (approved by the Council) nor the amended version is the policy of the ALI (because concurrence of both the Council and the Annual Meeting is necessary for such policy). The Tentative Draft provided that:

⁵ RESTATEMENT OF THE LAW OF LIABILITY INSURANCE, § 14(1) (Tent. Dr. No. 1 April 11, 2016) ("RESTATEMENT LLI").

⁶ *See, e.g.*, WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 3.02[4].

⁷ RESTATEMENT LLI § 14(2)(b).

⁸ RESTATEMENT LLI § 15, cmt. c.

Unless undisputed facts that are not at issue or potentially at issue in the complaint or comparable document stating the legal action for which a defense is sought establish as a matter of law that the legal action is not covered, the insurer must defend until its duty to defend is terminated.⁹

Under the amended version, an insurer may use extrinsic evidence to deny the duty to defend only in three specified situations:

(1) when undisputed facts demonstrate that the defendant in the action is not an insured under the insurance policy pursuant to which the duty to defend is asserted, (2) when undisputed facts demonstrate that the automobile involved in the accident at issue was not a covered automobile under the insurance policy pursuant to which the duty to defend is asserted, and (3) when undisputed facts demonstrate that a claim was reported late under a claims-made-and-reported policy in circumstances in which the notice-prejudice rule does not apply.¹⁰

Under either version, the insurer may, in other types of cases, seek a declaratory judgment that there is no duty to defend and may utilize extrinsic evidence in that action.¹¹

Moreover, if all of the facts and circumstances would have permitted the insurer to deny the defense, it can withdraw from a defense that it has undertaken.¹²

While some jurisdictions allow an insurer to consider a broader range of extrinsic evidence as a basis for denying a defense (at the risk of breaching the duty to defend if its view of those facts turns out to be incorrect), that rule is rejected.

The problem with this approach is the uncertainty it creates for insureds, who would in a wider range of situations be put in a position of having to finance their own defense and then to bring a separate breach-of contract action against their insurers to recoup those costs. The possibility of such an after-the-fact remedy would be of little comfort to insureds, who would find such litigation expensive and daunting. By contrast, under the rule followed in this Section ..., there is substantially less uncertainty borne by

⁹ RESTATEMENT LLI § 15(3).

¹⁰ RESTATEMENT LLI § 15, cmt. *c*. The amendment moved this language of the comment into the black letter.

¹¹ RESTATEMENT LLI § 18(8) & cmt. *j*.

¹² RESTATEMENT LLI § 18(7).

insureds regarding when they can expect to receive a defense from their liability insurer. As long as the complaint contains allegations that if proven, would form the basis of a covered action, or the insured can offer evidence outside of the complaint that supports coverage, the insured can be confident of receiving a defense.¹³

III. The Draft Restatement's Limits on Use of Extrinsic Evidence in Insurer Decision-Making on Duty To Defend Are Improperly Divorced from the Contractual Roots of the Duty To Defend and the Likely Interests of Those Who Purchase Liability Insurance

A. The Duty to Defend Depends Primarily on the Allegations of the Complaint

A typical liability policy insuring agreement (here taken from a Commercial General Liability policy) reads something like this:

We will pay those sums that the insured becomes legally obligated to pay as damages because of [specified types of injuries] to which this insurance applies. We will have the right and duty to defend the insured against any suit seeking those damages. We may, at our discretion, investigate any "occurrence" and settle any claim or "suit" that may result.¹⁴

This language promises both indemnification against certain types of liability and a defense against suits asserting such liabilities.¹⁵ Ordinarily, the duty to defend must be determined solely by examining the complaint against the insured in light of the insurance policy's coverage provisions.¹⁶ This is sometimes expressed as requiring coverage to be determined by facts within the "four corners" of the complaint or the "eight corners" of the

¹³ RESTATEMENT LLI § 13, cmt. *d*

¹⁴ See LEO P. MARTINEZ, MARC S. MAYERSON, DOUGLAS R. RICHMOND, *NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE* § 30.14[1][b] (2016).

¹⁵ See JEFFREY E. THOMAS & FRANCIS J. MOOTZ, III, *NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION* §§ 16.06, 17.01[1] (duty to defend), 18.01[1] (duty to indemnify).

¹⁶ See JEFFREY E. THOMAS & FRANCIS J. MOOTZ, III, *NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION* § 17.01[2][a].

complaint and the insurance policy.¹⁷ At least some form of this rule (sometimes referred to as the “exclusive pleading rule”) is followed in all American jurisdictions.¹⁸

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 facts; culpability is irrelevant. 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). And it 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?

The duty to defend is a contractual duty, so its scope depends on interpretation of the contract. The language and logic of the contract dictate that existence of the duty must ordinarily be determined from the allegations of the complaint. But courts often lose sight of both the logic and the contract itself. This can lead them into error in those situations where the logic of the contract not only permits, but demands, consideration of facts outside the allegations of the complaint.

Specifically, one must distinguish between “liability facts,” which will determine the existence or extent of the insured’s liability to the underlying plaintiff, and “nonliability facts,” which bear only on coverage (or are simply irrelevant). “Mixed facts,” which bear on both liability and coverage, are one variety of “liability facts.” Under standard policy language,

¹⁷ An extensive collection of cases on this issue can be found in Annot., *Allegations in third person’s action against insured as determining liability insurer’s duty to defend*, 50 A.L.R.2d 458 (1956 & Supp. 2006).

¹⁸ See LEO P. MARTINEZ, MARC S. MAYERSON, DOUGLAS R. RICHMOND, NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE § 30.14[3] (discussing variations).

liability facts must almost always be treated as they are alleged in the underlying complaint, while (in some jurisdictions) nonliability facts may be treated solely on the basis of actual evidence, with no regard to the allegations of the complaint.¹⁹

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

The “potential for coverage” rule derives from the standard policy language through a contractual construction explained by Judge Learned Hand in the seminal case of *Lee v. Aetna Casualty & Surety Co.*²⁰ Judge Hand reasoned that the insurer, having promised to defend, “has promised to relieve the insured of the burden of satisfying the tribunal where the suit is tried, that

¹⁹ Many commentators support use of use of extrinsic evidence on nonliability facts. 1 [NEW APPLEMAN LAW OF LIABILITY INSURANCE](#) Chs. 7–8 (collecting cases; “When the extrinsic facts relied on by the insurer are relevant to the issue of coverage, but do not affect the third party’s right of recovery, courts have held that the insurer may refuse to defend third-party actions even though the allegations in the complaint indicate coverage.”); 7C [JOHN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW & PRACTICE § 4684.01](#), at 90 & nn. 4–5, and at 93 & nn.18–19 (Berdal ed. 1979) (archive file) (collecting cases) (pleadings do not control and there is no duty to defend if defendant was not actually an insured or if coverage was defeated by some other facts irrelevant to the claim against the insured); [ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW § 9.3\(a\)\(1\)](#), at 1011–12 (1988) (insurer may avoid duty to defend by showing falsity of allegations unnecessary to claim against insured but suggesting coverage); [ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES, § 4.04](#) (6th ed. 2013, updated through 2016) (“an insurer should not have a duty to defend an insured when the facts alleged in the complaint ostensibly bring the case within the policy’s coverage, but other facts that are not reflected in the complaint and are unrelated to the merits of the plaintiff’s action plainly take the case outside the policy coverage”; “when coverage, i.e., the duty to pay, depends upon a factual issue which will not be resolved by the trial of the third party’s suit against the insured, the duty to defend may depend upon the actual facts and not upon the allegations in the complaint,” *quoting* *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7, 9 (N.J. 1970)); [STEPHEN S. ASHLEY, BAD FAITH ACTIONS: LIABILITY & DAMAGES § 4:04](#), at 4-7 (2d ed. 1997, updated through 2016) (no duty to defend if facts extrinsic to liability claim defeat coverage); Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 [MD. L. REV.](#) 1 (1999), [discussed at notes ___, below](#).

²⁰ *Lee v. Aetna Cas. & Sur. Co.*, 178 F.2d 750 (2d Cir. 1949) (NY law).

the claim as pleaded is ‘groundless.’”²¹ Consequently, “if the injured party states a claim, which, qua claim, is for an injury ‘covered’ by the policy ... it is irrelevant that the insurer may get information from the insured, or from any one else, which indicates, or even demonstrates” that the allegations of a covered basis of liability are false.²² The duty to defend has not been discharged until the court entertaining those allegations has been convinced that no liability of a type covered by the policy exists.²³

B. “Mixed” Allegations of Covered and Noncovered Conduct Must Be Defended, and Doubts as to Scope of Complaint Resolved in Favor of Coverage

In *Lee*, Judge Hand found uncertainty about application of the duty to a suit involving allegations of both covered and noncovered grounds for the same purported liability, but he concluded that the uncertainty should be resolved in favor of the insured. This conclusion is the basis of another of the now entrenched doctrines governing the duty to defend with respect to such mixed claims: “if the plaintiff’s complaint against the insured alleged facts which would

²¹ 178 F.2d 750 at 752.

²²

New York:

178 F.2d 750 at 751.

California:

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

²³

Texas:

GuideOne Elite Ins. Co. v. Fielder Road Baptist Church, 197 S.W.3d 305, 311 (Tex. 2006) (“if [the insurer] knows [the liability] allegations to be untrue, its duty is to establish such facts in defense of its insured”);

Ohio:

Grange Mut. Cas. Co. v. Rosko, 146 Ohio App. 3d 698, 710 (2001) (fact that jury found insured not negligent did not excuse failure to defend).

have supported a recovery covered by the policy, it was the duty of the defendant to undertake the defence, until it could confine the claim to a recovery that the policy did not cover.”²⁴

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

The *Lee* reasoning is almost universally applied, not only to mixed claims, but also to those where, due to the relatively unspecific nature of modern pleading, one cannot be sure whether the complaint asserts a covered claim.²⁵ But there are a few states which hold that an insurer is only obliged to defend covered claims.²⁶ The latter courts do not say how the insurer

24

New York:
Lee, 178 F.2d at 753.

Minnesota:
Jostens, Inc. v. CNA Ins. Co., 336 N.W.2d 544, 545 (Minn. 1983).

Utah:
United States Fid. & Guar. Co. v. Louis A. Roser Co., 585 F.2d 932, 936 (8th Cir. 1978).

See Jeffrey E. Thomas & Francis J. Mootz, III, *The New Appleman on Insurance Law Library Edition*, § 17.01[3][a].

see 22 Eric Mills Holmes, *Appleman on Insurance 2d*, § 136.2[D] (archive file)

²⁵ *Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co.*, 439 Mass. 387, 394 (2003) (“[I]f the allegations of the complaint are ‘reasonably susceptible’ of an interpretation that they state or adumbrate a claim covered by the policy terms, the insurer must undertake the defense”); see LEO P. MARTINEZ, MARC S. MAYERSON, DOUGLAS R. RICHMOND, *NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE* § 30.14[4][a].

²⁶

Alabama:
Tanner v. State Farm Fire & Cas. Co., 874 So. 2d 1058, 1065 (Ala. 2003);

might provide a partial defense or how defense counsel might defend against only some of the allegations against the insured, so insurers often provide full defenses, even where local law says that is not required. In any event, this commentary (like the Restatement) accepts the *Lee* reasoning on the point.

Taken together, these rules constitute what is commonly described as the “potential for coverage” rule. It combines the express contractual duty with ancillary duties necessary to provide the insured with the full benefit of the express duty. The duty to defend is an express promise to satisfy the court in which the insured is sued (on a claim that would be covered if established) that the claim is groundless. The insured ought not to lose the promised benefit of a full defense of covered claims merely because the plaintiff also includes noncovered ones in the complaint. So, where covered claims are joined with noncovered ones, the insurer must also provide whatever defense is necessary for the noncovered claims while it is disposing of the covered ones. Similarly, given the vagueness of notice pleading, the insured ought not to be deprived of a full defense of a covered claim merely because the complaint was unclear on whether that was one of the claims asserted. Accordingly, ambiguities in the complaint must be construed in favor of coverage until those ambiguities can be resolved.

C. Like the Restatement, Many Jurisdictions Require Consideration of Extrinsic Facts Showing Potential for Coverage Not Evident From Allegations

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

Washington:
Waite v. Aetna Cas. & Sur. Co., 77 Wash. 2d 850, 855 (1970).

the complaint, indicate that the claim is within or potentially within the policy coverage.”²⁷

Again, this article has no quarrel with that rule, which is followed by the Restatement.²⁸

D. Under the Contractual Logic of the Duty to Defend, an Insurer Should Be Able to Deny a Defense if It Correctly Determines That Nonliability Facts Preclude Coverage

1. The Difference Between Liability Facts and Nonliability Facts

To repeat, the language of the contract dictates that the insurer is bound, for duty-to-defend purposes, by the allegations of the complaint, but *only* those allegations contributing to establishing the liability of the insured. Only liability-creating allegations create the obligation to “satisfy[] the tribunal where the [tort] suit is tried that the claim as pleaded is ‘groundless.’” For purposes of the duty to defend, liability-creating allegations of the tort complaint are actual facts insofar as they identify the matters that the insurer is obliged to refute in the tort action. On that understanding, the duty to defend, like all other contractual duties, is determined by actual facts. All aspects of policy coverage not dependent on liability-determining allegations should be determined, under the usual contract rule, according to the actual facts.

An example of a coverage issue involving only nonliability facts is *Chandler v. Doherty*.²⁹ Otis Doherty had two cars: (1) a Chevrolet and (2) a Volkswagen chassis with a replica of a 1927 Bugatti body (the “replicar”). He had an insurance policy with American Fire on the Chevrolet, but no policy covering the replicar. The Chevrolet policy explicitly excluded any liability coverage for any car owned by Doherty but not insured under the policy. Doherty had an accident in the replicar, injuring Verna Chandler. She sued, alleging that he was operating “his car,” but not which one. American Fire denied a defense, because it was

²⁷ See JEFFREY E. THOMAS & FRANCIS J. MOOTZ, III, NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION §§ 17.01[2][b][ii] (collecting cases), 17.05[2][a].

²⁸ RESTATEMENT LLI § 14(b)(2) & cmts. & .

²⁹ *Chandler v. Doherty*, 299 Ill. App. 3d 797 (1998).

undisputed that the uninsured replicar was the one in the accident.³⁰ The Illinois Appellate Court held that American Fire wrongfully denied a defense, because it was required to ignore the undisputed (but extrinsic) fact that Doherty was driving a car not insured under *any* contract, with American Fire or anyone else.³¹ Liability in the suit against Doherty depended entirely on how the car was operated, not on whether it was the Chevrolet or the replicar. So coverage depended entirely on nonliability facts.

The Restatement would allow denial of coverage in this situation, either through a general authorization to use undisputed nonliability facts or through a special exception for undisputed facts concerning whether the car was insured.³² Either alternative differs from the rule advocated here, but discussion of the differences follows the analysis supporting the rule advocated here.

Courts that refuse to allow insurers to consider some or all evidence of nonliability facts, while in a majority, have lost sight of the fact that the scope of the duty to defend is a matter of contract. Understandably, they are accustomed to looking to prior cases construing the same standardized contractual provisions rather than analyzing those provisions anew in every case. This process leads to error when courts apply the general rules stated in prior cases without understanding the contractual logic that generated those rules. When the wording of the interpretive gloss is substituted for the contractual language, the meaning is inevitably distorted, especially where the court providing the gloss was concerned with a problem different from that before the court seeking to rely on that gloss. In extreme cases, courts may even forget that they are construing a contract rather than making common law that best suits judicial views of public policy.

³⁰ 299 Ill. App. 3d at 798-800.

³¹ 299 Ill. App. 3d at 802-04.

³² See discussion at notes ___, *above*.

The Restatement is, of course free (in terms of the ALI's rules) to state a common-law rule divorced from the contractual roots of the duty, at least where courts have done so. But courts are not equally free to adopt such rules when the scope of the duty depends on construing the contract. Nor, even were they free, should they do so without a clear basis to conclude that doing so would be good policy. No such basis is provided by the Restatement.

2. Prof. Pryor's Analysis

a) What Rules Would Insurance Purchasers Prefer?

In a series of articles, Professor Ellen S. Pryor has examined the extrinsic evidence issue to determine what set of decisional rules purchasers of insurance would prefer if they were adequately informed and offered a choice, with the premium to be charged varying in accordance with the projected cost to the insurer of each set of rules.³³ Insureds would be more fully protected by a duty to defend that is broader and harder to defeat, but the additional protection would be accompanied by additional costs. If insureds would prefer not to incur the extra costs, then the optimal defense coverage would be narrower.

b) Reasons for Limitations on Indemnity Coverage

Prof. Pryor's analysis begins by examining the reasons for the various limitations on indemnity coverage found in liability insurance policies.³⁴ Some are based on consumer demand. For example, business pursuits exclusions in homeowners insurance policies reflect the fact that consumers who do not use their homes for business purposes prefer not to pay the extra cost of insurance that would cover the risks of such pursuits. Speaking actuarially, they do not

³³ Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1754-60 (1997) [hereinafter *Stories*]; Ellen S. Pryor, *The Tort Liability Regime and the Duty To Defend*, 58 MD. L. REV. 1 (1999) [hereinafter *Tort Regime*]; Ellen S. Pryor, *Mapping the Changing Boundaries of the Duty To Defend in Texas*, 31 TEX. TECH. L. REV. 869, 890-97 (2000) [hereinafter, "*Mapping*"]. The issue addressed here concerns consideration of extrinsic evidence outside the context of a coverage action, so Prof. Pryor's analysis regarding use in coverage actions is not discussed here.

³⁴ Pryor, *Tort Regime*, 58 MD. L. REV. at 14-16.

wish to have their risks pooled with the dissimilar risks of those who are engaged in business. Such an exclusion forces those with business risks to purchase special endorsements or independent commercial liability policies at an appropriate extra premium.

Some limitations, such as pollution exclusions, reflect the concerns of the insurers supplying the coverage, who “might decide that a risk is too difficult to predict, that adverse selection with respect to this risk will be too great, or that the risk is too highly correlated.”³⁵

Finally, some limitations, such as intentional injury exclusions, reflect both supply and demand considerations:

From the insurer’s perspective, intentionally controlled losses are, in the main, not actuarially predictable, and they pose moral hazard and adverse selection problems that further undermine their insurability. From the insured’s perspective, too, the purchase of insurance for such losses might not be sensible. For most insurance purchasers, it would be cheaper to engage in prevention activities—that is, to avoid intentionally harmful behavior—than to purchase insurance for it, even if such insurance could be purchased at an actuarially fair price. In addition, although individuals rationally purchase insurance against the possibility of erroneous liability findings, insureds could plausibly decide that an erroneous jury finding of intentional harm is less likely than an erroneous finding of negligence.³⁶

But, subject to supply-side limitations, insureds would want coverage for the risks posed by their respective expected activities, but not for activities in which they do not expect to engage. Defense coverage is customarily bundled with indemnity coverage both because insureds want protection against the costs of defense and because insurers need to have suits well defended in order to control indemnity exposure.³⁷ Insureds would not want coverage for

³⁵ Pryor, *Tort Regime*, 58 MD. L. REV. at 14.

³⁶ Pryor, *Tort Regime*, 58 MD. L. REV. at 15 (footnotes omitted).

³⁷ Pryor, *Tort Regime*, 58 MD. L. REV. at 9-12. Some large commercial insureds handle their own defense within self-insured retentions. Pryor, *Tort Regime*, 58 MD. L. REV. at 13. Insurers trust their ability and incentive to mount a proper defense, and retaining this risk can be cheaper than insuring it.

defense to turn on the merits of the suits against them; unmeritorious suits pose significant risks.³⁸

It also makes sense for the boundaries of defense coverage to track the limits on indemnity coverage. One would expect that an insured who does not want indemnity coverage for business uses of his boat either expects not to make such uses or expects indemnity from another source, such as an employer. So, there would be little value in having defense coverage for such uses.³⁹

c) Determining the Correct Decisional Structure

With that groundwork laid, Professor Pryor turns to what she calls “the decisional structure for coverage questions under defense insurance,” namely, the extent to which extrinsic evidence may be considered.⁴⁰ Because we are considering what type of insurance purchasers would want, not how to construe particular policy language, the rules about construing in favor of the insured and honoring reasonable expectations do not apply.⁴¹ (In the context of the Restatement, those rules do not apply, because the limit on use of extrinsic evidence to deny a defense is a mandatory rule, not subject to alteration by contractual language.⁴²)

In an ordinary first-party insurance case, for disability or property damage, the insurer assesses the actual facts surrounding the claim and pays or denies the claim in accordance with its view of the facts. If the claim is denied or the insured thinks the payment too small, the insured can sue for breach of contract. Any further payment will depend on an adjudication, again based on the actual facts. Moreover, that is the general rule governing indemnity coverage,

³⁸ Pryor, *Tort Regime*, 58 MD. L. REV. at 16.

³⁹ Pryor, *Tort Regime*, 58 MD. L. REV. at 17.

⁴⁰ Pryor, *Tort Regime*, 58 MD. L. REV. at 17.

⁴¹ Pryor, *Tort Regime*, 58 MD. L. REV. at 27.

⁴² See RESTATEMENT LLI § 13 (making no provision for alteration by contractual language).

though much of the adjudication of the actual facts takes place in the tort case, rather than in a later coverage action.

If defense coverage depended solely on actual facts, as contrasted with allegations in the tort complaint, defense would be necessary less often. Moreover, the duty to defend claims that ultimately would not be indemnifiable creates settlement value for those claims, while defense coverage based solely on actual facts would do so less often and in smaller amounts. If the insurer is not allowed to litigate coverage based on actual facts until the tort action has concluded, coverage issues will linger and cause conflicts of interest and increase collateral disputes.⁴³

This analysis leads to the initial conclusion that “[p]resumably, defense insurance governed by the actual facts would be cheaper than defense insurance under the complaint allegation rule. The insured, then, would prefer an actual facts approach unless this would deliver inadequate coverage or pose real risks of decisional abuse.”⁴⁴

Of course, the benefits must be weighed against the costs. Some of those costs do not appear to call for a different “decisional structure” than for other insurance.⁴⁵ The need to decide at the outset whether to provide a defense would require more investigation by insurers, but they could always accept the allegations until the investigation was complete, or dispense with the investigation entirely if it were deemed too costly. Making coverage turn on actual facts would likely increase the number of cases in which an insurer would incorrectly deny coverage, forcing the insured to sue. But this is no different from other types of insurance, which already depend on actual facts. And abuse can be controlled by extracontractual remedies—awards of attorneys

⁴³ Pryor, *Tort Regime*, 58 MD. L. REV. at 17-21.

⁴⁴ Pryor, *Tort Regime*, 58 MD. L. REV. at 28.

⁴⁵ Pryor, *Tort Regime*, 58 MD. L. REV. at 28-29.

fees or bad faith actions for breach of duty to settle or baseless withholding of benefits—as it is with other types of insurance.

Defense insurance, however, does present some special concerns, especially as to issues overlapping between liability and coverage.⁴⁶ These concerns arise because the insured would be forced to litigate the coverage action at the same time as the tort action. In some cases, this would require the insurer’s litigation interests to be aligned with those of the plaintiff, if the coverage defense asserted the truth of some of the tort allegations. Even if that were not the case, litigation options in the tort case might be limited by actions or positions taken in the coverage case. So, at least with respect to an insurer’s initial decision whether to defend, Professor Pryor concludes that “[t]hese concerns make a solid case for retaining the complaint allegation approach when the insurer’s coverage argument depends on extrinsic facts that overlap with the liability case.”⁴⁷

Professor Pryor observes that most courts probably apply the eight-corners rule to initial decisions but allow adjudication of purely coverage issues in concurrent coverage actions.⁴⁸ She describes this as a “defeasible eight-corners” rule.⁴⁹ It is similar to the rule stated by the Restatement, though the latter rule allows use (in initial decisions) of certain actual facts (which ones being uncertain as the Council and Annual Meeting approved different language).⁵⁰

⁴⁶ Pryor, *Tort Regime*, 58 MD. L. REV. at 29-31.

⁴⁷ Pryor, *Tort Regime*, 58 MD. L. REV. at 31. The ways in which the tort defense could be prejudiced are also discussed in Pryor, *Stories*, 75 TEX. L. REV. at 1759.

⁴⁸ Pryor, *Tort Regime*, 58 MD. L. REV. at 48-49, relying on 2 ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES § 8.03.

⁴⁹ Pryor, *Mapping*, 31 TEX. TECH. L. REV. at 896. She attributes this term to Michael Sean Quinn, *The Duty to Defend: New Texas Developments*, 19 INS. LITIG. REP. 193 (May 1997), cited in 31 TEX. TECH. L. REV. at 896 n.196.

⁵⁰ See text at notes ___, above.

Allowing use of extrinsic evidence in initial determinations, as long as the adjudication later confirms lack of coverage, is described by her as an “actual facts” rule.⁵¹

In her view, the actual facts rule “is acceptable in theory, since it matches the level of defense insurance that is optimal in theory.”⁵² But it would depend on correctly drawing the line between purely coverage facts and overlapping facts, which sometimes presents difficulties in practice.⁵³

A defeasible eight-corners rule would avoid that uncertainty by having the court determine that line, but it would require the insurer to defend until it obtained a coverage adjudication. Moreover, it would prolong the opportunities for structural collusion between the insured and the tort plaintiff and increase the occasions for dispute about the insurer’s handling of the case during the period before coverage is adjudicated.⁵⁴

Professor Pryor concludes that for purely coverage issues:

On balance, the actual facts approach seems preferable. It delivers the appropriate level of defense insurance in theory, and the usual breach of contract and extracontractual remedies would be available for mistakes or abuses in the application of the approach. Indeed, as just noted, it appears that many courts have been applying something akin to this approach by allowing the actual facts to govern, from the outset, with respect to questions such as the identity of the insured or the insured vehicle.⁵⁵

But an insurer that relies on extrinsic evidence on what is later found to be an overlapping issue will have breached the duty to defend and will suffer the unpleasant consequences of such a breach.⁵⁶ That rule will provide an incentive for insurers to defend under reservation when the coverage/overlapping question is not clearcut, presumably while bringing a concurrent coverage

⁵¹ Pryor, *Tort Regime*, 58 MD. L. REV. at 49.

⁵² Pryor, *Tort Regime*, 58 MD. L. REV. at 51.

⁵³ Pryor, *Tort Regime*, 58 MD. L. REV. at 51. See discussion at notes __ above.

⁵⁴ Pryor, *Tort Regime*, 58 MD. L. REV. at 51.

⁵⁵ Pryor, *Tort Regime*, 58 MD. L. REV. at 52 (footnotes omitted).

⁵⁶ Those consequences are discussed at notes __, below.

action to resolve both that issue and, hopefully, the coverage issue.⁵⁷ It will also provide adequate compensation and protection to insureds.⁵⁸

E. The Restatement Rule Is Not Justified by Analysis

1. The Restatement Rule Is Contrary to the Contractual Logic

a) The Restatement Rule and Rationale

The Restatement argues that

[t]he problem with [an actual facts] approach is the uncertainty it creates for insureds, who would in a wider range of situations be put in a position of having to finance their own defense and then to bring a separate breach-of contract action against their insurers to recoup those costs. The possibility of such an after-the-fact remedy would be of little comfort to insureds, who would find such litigation expensive and daunting. By contrast, under the rule followed in this Section . . . , there is substantially less uncertainty borne by insureds regarding when they can expect to receive a defense from their liability insurer. As long as the complaint contains allegations that if proven, would form the basis of a covered action, or the insured can offer evidence outside of the complaint that supports coverage, the insured can be confident of receiving a defense.⁵⁹

But there is no reason why insureds who are in fact not entitled to a defense should be given confidence in receiving it. Nor is that necessary, even for insureds who might be incorrectly denied a defense, so long as the law provides adequate remedies when that occurs. Adequacy of remedies is discussed in III.E.2, after examining the ways in which the Restatement rule deviates from the contractual logic of the duty to defend.

As amended at the ALI Annual Meeting, an insurer would be permitted to use extrinsic evidence to deny the duty to defend only in three specified situations:

(1) when undisputed facts demonstrate that the defendant in the action is not an insured under the insurance policy pursuant to which the duty to defend is asserted, (2) when undisputed facts

⁵⁷ Pryor, *Tort Regime*, 58 MD. L. REV. at 53.

⁵⁸ See discussion at notes ___, below.

⁵⁹ RESTATEMENT LLI § 13, cmt. *d*

demonstrate that the automobile involved in the accident at issue was not a covered automobile under the insurance policy pursuant to which the duty to defend is asserted, and (3) when undisputed facts demonstrate that a claim was reported late under a claims-made-and-reported policy in circumstances in which the notice-prejudice rule does not apply.⁶⁰

The draft approved by the ALI Council grants a broader authorization:

Unless undisputed facts that are not at issue or potentially at issue in the complaint or comparable document stating the legal action for which a defense is sought establish as a matter of law that the legal action is not covered, the insurer must defend until its duty to defend is terminated.⁶¹

The latter draft explains that its formulation "provides a more general statement of [the enumerated] exceptions." As yet, no explanation has been offered for restricting the authorization to an exclusive list. That seems contrary to the method of the common law (which the Restatement purports to represent): the common law proceeds by ruling on particular facts, developing general rules that may be applied to other sets of facts.

b) The Requirement of Undisputed Evidence Is Improper

Under the analysis offered here, even the version approved by the ALI Council is unduly narrow. The primary objection is to the requirement that the facts establishing lack of coverage be undisputed.

An illustrative case is *Amato v. Mercury Casualty Co.*⁶² Amato was in an accident injuring his mother-in-law, Sutton. His policy excluded coverage for injuries to insureds, including resident relatives of the named insured. There was a dispute as to whether, at the time of the accident, Amato had ceased to reside with Sutton, but Mercury concluded that she did and denied coverage, refusing to defend. In the coverage action, a jury found that they did still reside

⁶⁰ RESTATEMENT LLI § 15, cmt. *c*. The amendment moved this language of the comment into the black letter.

⁶¹ RESTATEMENT LLI § 15(3).

⁶² *Amato v. Mercury Casualty Co.*, 18 Cal. App. 4th 1784 (1993).

together, but the superior court found that Mercury had nonetheless breached the duty to defend.⁶³

The court of appeal affirmed on the ground that Mercury had ascertained facts supporting the possibility that Sutton and Amato did not reside together and that this created a potential for coverage so long as that issue was disputed; the court thought this logic reinforced by the fact that the insurer had not discovered, at the time it denied the defense, the key evidence showing that Sutton and Amato still resided together at the time of the accident.⁶⁴ That would seem to be the logic behind the Resatement's requirement of undisputed facts.

But, as previously explained,⁶⁵ the contractual logic of the potential for coverage rule applies only to liability facts, those which the insurer is obliged to satisfy the court in the underlying action do not support liability. Whether Sutton and Amato resided together was irrelevant to liability, so there was no occasion to address that in the underlying action. Coverage should have depended on the actual facts, and a jury found those facts in favor of Mercury. As with other contract obligations, it ought not to have mattered what Mercury did or did not know about those facts at the time it denied the defense.

c) Even Allegations About Liability Facts May Not Be Binding in Determining Whether Defendant Is Insured

The contractual logic making complaint allegations binding is based on the scope of the contractual promise. But the scope of the promise only matters if the person seeking a defense is a promisee or beneficiary of the contract—an “insured person.” All of foregoing analysis here presupposes the existence of an actual contract with ascertainable terms. The existence and terms of the contract clearly should be determined by the actual facts, not by the allegations of the

⁶³ 18 Cal. App. 4th at 1788-89

⁶⁴ 18 Cal. App. 4th at 1789-93.

⁶⁵ See text at notes ___, *above*.

complaint. This does not seem controversial. Indeed, it is implicit in the characterization of the exclusive pleading rule as the “eight-corners rule.”

Whether the tort defendant is an insured at all should depend on actual facts, even if those facts are mixed facts. Analytically, this use of actual facts should be permissible even if a jurisdiction otherwise follows a four-corners rule.

Courts are divided on whether to permit use of extrinsic evidence to determine status as an insured if that evidence is not otherwise permissible. The debate is exemplified by the majority and dissenting opinions in *Colon v. Aetna Life & Casualty Corp.*⁶⁶ *Colon* was involved in an accident while driving a car owned by Palmier Oil Corporation that he had no permission to drive. Aetna insured Palmier but denied *Colon* a defense, based on the lack of permission. (In the terms just discussed, permissive use was a liability issue as to Palmier, which was also sued, but purely a coverage issue as to *Colon*.) The New York Court of Appeals held that the permissive use allegation in the tort complaint controlled on the coverage issue “where the issue of permission has not been judicially resolved prior to trial of the personal injury action.”⁶⁷ The majority reasoned that:

[s]o long as the issue of permission remains unresolved, the effective defense of the driver is in the interest of the insured, who stands at risk on both the issue of permission and on the underlying issue of negligence. While the named insured may have an incentive to take the position that the driver was operating the vehicle without consent he also has a strong interest in seeing that the driver obtains a competent defense, so as to avoid prejudice to himself—should permission be found—on the issue of negligence. Additionally, Aetna’s decision not to defend *Colon* was based solely on its own investigation. While there is no allegation of bad faith, a contrary holding might encourage refusals to defend where the circumstances were less clear, because there would be little risk in doing so. If the person denied a defense were subsequently found to have been operating the vehicle without consent, the

⁶⁶ *Colon v. Aetna Life & Casualty Corp.*, 66 N.Y.2d 6, 494 N.Y.S.2d 688, 484 N.E.2d 1040 (N.Y. 1985).

⁶⁷ 66 N.Y.2d at 9 [494 N.Y.S.2d at 690, 484 N.E.2d at 1041–42].

insurer would have incurred no cost and if consent were found the insurer would merely reimburse the attorneys' fees it would have incurred anyway. While the dissent suggests that any abuses by insurers could be redressed in litigation with their insureds, as a policy matter we prefer the course that places the duty of defense initially on the insurer, for the benefit of the insured.⁶⁸

While the *Colon* court purports to require a defense “for the benefit of the insured,” the very issue was whether Colon was an insured. (Of course, the insurer presumably did litigate permissive use on behalf of Palmier.) The dissent refused to “accept the notion that an insurance carrier is obligated to provide a defense to stranger simply because the plaintiff alleges facts which, if true, would bring the stranger within the ambit of an omnibus clause providing coverage for” permissive users.⁶⁹ “Taken to its logical conclusion, the majority would require the carrier to supply counsel to a thief.”⁷⁰ The tort plaintiff could not be forced to litigate the issue in a coverage action, and both the tort plaintiff and the driver would resist any summary judgment

68

New York:
66 N.Y.2d at 10 (citation omitted).

Accord:

Louisiana:
American Home Assur. Co. v. Czarniecki, 230 So.2d 253, 269 (La. 1970) (where complaint had alleged permissive use, insurer had duty to defend, even though indemnity coverage did not exist because there was no actual permission);

Texas:
Heyden Newport Chem Corp. v. So. Gen. Ins. Co., 387 S.W.2d 22, 25 (Tex. 1965);

Washington:
Holland Am. Ins. Co. v. Nat'l Indem. Co., 75 Wn. 2d 909, 913 (1969).

⁶⁹ *Colon*, 66 N.Y.2d at 10 (dissenting opinion).

⁷⁰ 66 N.Y.2d at 10. (Colon's brother, a Palmier employee, had been a permissive user and had allowed Colon to use the car contrary to Palmier's instructions. So Colon himself was not a thief.).

on that issue in the tort action. Furthermore, the need to pay for a defense until a summary judgment could be obtained would eliminate much of the benefit of the coverage defense.

Courts have predominantly supported allowing an insurer to deny a defense in such circumstances.⁷¹ That is the correct rule: purchasers of insurance policies have no reason to pay for the defense of those not actually insured under those policies, even if a plaintiff alleges facts that, if true, would have made them insureds.

d) Even Liability Facts Can Be Considered if Insured Cannot Be Defended with Respect to Such Facts

The purpose of the exclusive pleading rule is to require the insurer to convince the court hearing the tort suit that the allegations against the insured are false. That is problematic where the essence of the coverage defense is that some of those allegations (*e.g.*, that the insured intentionally injured the plaintiff) are true. In such cases, the insurer's coverage interests are

⁷¹ *E.g.*,

Texas:

[Blue Ridge Ins. Co. v. Hanover Ins. Co.](#), 748 F. Supp. 470, 473 (N.D. Tex. 1990) (actual facts determine who is an insured, so long as those facts do not overlap tort action);

Arizona:

[Granite State Ins. Corp. v. Mountain States Telephone & Telegraph Co.](#), 573 P.2d 506, 509-10 (Ariz. Ct. App. 1978) (relying on fact that coverage issue did not overlap tort case);

Illinois:

[Employers Mut. Cos. v. Country Cos.](#), 570 N.E.2d 528, 531 (Ill. App. Ct. 1991) (“two conditions must be met before an insurer’s duty to defend arises: (1) the action must be brought against an insured, and (2) the allegations of the complaint must disclose potential coverage under the policy”) (citation omitted);

Utah:

[McCarty v. Parks](#), 564 P.2d 1122, 1124 (Utah 1977).

adverse to some of the insured's interests. If an insurer provides defense in such a case, the insured would need to be given independent counsel.⁷²

For present purposes, what is more important is that exclusive reliance on the allegations of the complaint seemingly precludes denial of a defense, even if the actual facts show convincingly that the insured's liability is for an excluded claim. But there is one special situation where use of extrinsic evidence is consistent with the contractual logic.

That situation occurs where it is impossible, on behalf of the insured, to dispute an allegation which establishes a coverage defense. Suppose, for example, that the insured admits an intentional assault of the plaintiff or has been criminally convicted of such an assault, in a jurisdiction where a conviction has collateral estoppel effect. In such circumstances, the insurer ought to be able to rely on the indisputable fact to defeat the duty to defend.⁷³

⁷² WILLIAM T. BARKER & RONALD D. KENT, *NEW APPLEMAN INSURANCE BAD FAITH LITIGATION*, SECOND EDITION § 3.05.

⁷³ *E.g.*,

Illinois:

Amer. Family Mut. Ins. Co. v. Savickas, 193 Ill. 2d 378, 391 (Ill. 2000);

Maine:

State Mut. Ins. Co. v. Bragg, 589 A.2d 35, 38 (Maine 1991) (criminal conviction could be used in coverage action to negate duty to defend);

Michigan:

Aetna Cas. & Sur. Co., 415 N.W.2d 230, 231–32 (Mich. Ct. App. 1987) (murder conviction defeats duty to defend);

New York:

Home Mut. Ins. Co. v. Lapi, 596 N.Y.S.2d 885, 887 (N.Y.A.D. 1993) (conviction negated duty to defend without need for coverage action). *But see:*

Michigan:

Dochod v. Cent. Mut. Ins. Co., 264 N.W.2d 122, 124 (Mich. Ct. App. 1978) (court could not consider insured's admission of intent to injure);

New York:

2. The Remedies for Breach of the Duty To Defend Are Adequate

The Restatement's limits on the use of extrinsic evidence to deny a defense are justified on the ground that those restrictions provide greater certainty of a defense to insureds who would find it daunting to have to defend and sue the insurer for reimbursement.⁷⁴ If that were the only remedy for breach, that justification might have some merit. But the law provides other, better remedies which are adequate.

Contract law provides a range of remedies, including compensatory damages, but collectively of greater power and practical significance.

- The insured is free to take a covenant not to execute and then default, allowing an uncontested prove up, whose result will bind the breaching insurer; failure of the insured to mitigate damages will not preclude enforcement of the judgment by the claimant.⁷⁵
- Alternatively, the insured can protect himself or herself by taking a covenant not to execute and settling with the claimant. The settlement will be enforceable if reasonable (or, in some jurisdictions, merely nonfraudulent).⁷⁶ The risk of unenforceability falls solely on those claimants who extract agreements to unreasonable settlement amounts.
- Even if the insured cannot or does not obtain a covenant not to sue, the insurer will be liable for any covered judgment and for any noncovered portion of a judgment that could have been avoided by proper defense and could not have

Kincaid v. Simmons, 414 N.Y.S.2d 407, 410 (N.Y.A.D. 1979) (court could not consider insured's admission that operations had been complete).

⁷⁴ RESTATEMENT LLI § 13, cmt. *d* (quoted at note __, *above*).

⁷⁵ WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION §§ 1.04[2], 4.04[1].)

⁷⁶ WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 4.04[2].

been avoided by reasonable steps the insured could have taken to mitigate damages.⁷⁷

- If the insured incurred any defense costs, they are recoverable.⁷⁸
- The result is almost sure to be an inflated judgment, unless liability were clear and the damages clearly in excess of limits (in which case settlement duties would also be implicated and provide additional remedies).
- And, if the breach were found to be in bad faith, tort damages and even punitive damages might be recoverable.⁷⁹

An impecunious insured generally suffers no harm beyond possible credit damage from a judgment that can never be enforced, and even that would seem a recoverable item of contractual damages if it occurred.⁸⁰ (The more impecunious the insured, the less credit the insured would have had even without the unenforceable judgment.) And the insured could explain to potential creditors that the judgment could not be enforced.

The adequacy of these remedies to protect impecunious insureds is supported by the observation that

impecunious policyholders ... 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 [Restatement] Reporters, Tom Baker, made this point in an excellent article that has been cited widely. Professor Baker argued that the practice of collecting only from insurers reflects a professional norm. Other researchers have argued that the practice has a simple economic explanation: going after defendants' personal assets usually is more of a bother

⁷⁷ WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION §§ 1.04[2]–[4].

⁷⁸ WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 1.04[1].

⁷⁹ WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § 3.08[3].

⁸⁰ WILLIAM T. BARKER & RONALD D. KENT, NEW APPLEMAN INSURANCE BAD FAITH LITIGATION, SECOND EDITION § § 1.01[2][b].

than it is worth. 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 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.⁸¹

An insured with substantial assets may not be able to extricate itself with a covenant not to execute. But such an insured can either defend and recover later or reach some sort of agreement to cooperate with the claimant against the insurer.

All told, these rules provide strong incentives for insurers to avoid breaching the duty to defend and good remedies for insureds and claimants when breaches occur.

IV. Conclusion

The Draft Restatement should be revised to comport with the contractual logic described in this article.

⁸¹ Charles Silver & William T. Barker, *The Treatment of Insurers' Defense-Related Responsibilities in the Principles of the Law of Liability Insurance: A Critique*, 68 RUTGERS U. L. REV. 83, 98-99 (2015) (footnotes omitted). The article discussed in the quote is Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOC'Y REV. 275 (2001).