

THE DUTY TO DEFEND: 2003

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I. TRIGGERING THE DUTY TO DEFEND

No single feature of a liability insurance policy has a greater impact upon an insurer's ultimate payment obligations than the duty to defend. An insurer's decision as to whether it has a duty to defend or not can have significant ramifications throughout the course of a claim both as regards to the insurer's immediate payment obligations, the course of conduct that a policyholder is likely to adopt as regards the third-party tort claimant and, in some jurisdictions, with respect to whether the insurer, if found to have a duty to defend, now owes attorneys' fees, consequential damages or may even be estopped to dispute whether it has an indemnity obligation.

The insuring agreement in a CGL policy provides that:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury or property damage to which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient, but the company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.

It bears recalling that this defense undertaking is not only a *duty* but a *right*. The *right* to defend is a valuable tool bargained for by insurers in the creation of such policies. The right to defend gives an insurer complete control over the manner in which a case is defended and ultimately disposed of. This can have great significance as to the ultimate cost of defense and in ensuring that the case is resolved on its merits.

There are three prerequisites to triggering a duty to defend: (1) the policy must contain a contractual promise to defend; (2) a "suit" must have been filed against the insured and (3) the insured must tender the defense of that suit to the insurer.

1. ***A Contractual Promise to Defend***

Most general liability policies explicit language in the insuring agreement setting forth the insurer's right and duty to defend. A duty to defend is sometimes also included in umbrella liability policies, especially where a covered claim is presented that is outside the scope of the underlying primary layer of insurance. As will be discussed in Part IX of this series, however, excess policies typically only pay for defense cost as part of the insured "ultimate net loss."

There are two major distinctions paying defense costs pursuant to an indemnity obligation and having an independent duty to defend.

First, such payments are subject to an *indemnity* standard of proof. Unlike the duty to defend, which is based on a mere potential for coverage, the insurer's indemnity obligation rests on whether the insured's actual liability is based on covered facts.

Second, whereas a primary insurer's defense obligation exists independently of its indemnity limits, defense costs paid by excess insurers generally count against limits and may therefore combine with indemnity payments to exhaust the available coverage.

Nevertheless, a handful of courts have implied a duty to defend even where it is not expressly provided for in the policy. For instance, Section 2778, Subdivision (4) of the California Civil Code provides that a defense obligation will be implied in all indemnity agreements unless a contrary intention appears. In Maryland Casualty Co. v. Nationwide Ins. Co., 65 Cal. App.4th 21, 76 Cal. Rptr.2d 113 (4th Dist. 1998), the California Court of Appeal ruled that an insured may reasonably expect to have a defense provided unless its policy expressly excludes such an obligation.

2. The Filing of a Law Suit

Generally, there is no duty to defend mere claims. Marvel Heat Corp. v. Travelers Ind. Co., 92 N.E.2d 233, 234 (Mass. 1950). Even though the insured is required in most liability policies to give immediate written notice upon receipt of a claim, the purpose of such notice requirements is for the insurer's benefit (to give the insurer a full opportunity to investigate and respond to the claim). Indeed, the insuring agreement gives the insurer the right to settle or otherwise respond to claims, at its discretion. However, a defense obligation does not arise until a suit is filed.

Some courts have recognized two narrow exceptions to this general rule: (a) governmental environmental enforcement claims and (b) cases in which emergency pre-suit activity is required.

(a) Governmental Environmental Liability Demands

A few courts have declared that environmental liability claims by governmental authorities are the "functional equivalent" of a lawsuit as they may result in significant liabilities and monetary fines or damages being imposed upon a policyholder even without the formal commencement of a lawsuit. See, e.g. Hazen Paper v. USF&G, 407 Mass. 687 (1990) and SCSC Corporation v. Allied Mutual Ins. Co., 533 N.W.2d 603 (Minn. 1995). Not all courts have agreed, however. See Lapham-Hickey Steel Corp. v. Protection Mutual Ins. Co., 655 N.E.2d 842 (Ill. 1995); City of Edgerton v. General Cas. Co. of Wisconsin, 517 N.W.2d 463 (Wis. 1994) and Foster-Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, 18 Cal. App. 4th 857, 959 P.2d 265, 77 Cal. Rptr.2d 107 (1998)(rejecting "functional equivalent" analysis).

Even in the environmental context, most courts have ruled that mere requests for information or less adversarial communications are not a "suit." Carpentier v. Hanover

Ins. Co., 670 N.Y.S.2d 540 (2d Dept. 1998) (distinguishing between types of letters). See also Zecco, Inc. v. Travelers Ind. Co., 938 F.Supp. 65 (D. Mass. 1996)(private PRP claim not a “suit”).

(b) *Pre-Suit Tasks*

Outside of the environmental area, most courts have agreed that there is no right to recover pre-suit costs except perhaps in extraordinary cases where litigation is inevitable and pre-suit costs of investigation are undertaken before the lawsuit is actually commenced in order to preserve evidence or otherwise undertake measures that cannot be delayed but are necessary to a successful defense. See Liberty Mutual Ins. Co. v. Continental Cas. Co., 771 F.2d 579 (1st Cir. 1985)(Massachusetts law).

As a practical matter, an insurer may well be willing to pay for such costs if the work is truly justified and needs to be done immediately if the insurer is ultimately going to take over the defense anyway. What is required is that the insured at least give the insurer advance notice and an explanation if it expects or hopes to obtain payment later. See Towne Realty, Inc. v. Zurich Ins. Co., 548 N.W.2d 64 (Wis. 1996)(rejecting insured’s contention that emergency circumstances warranted reimbursement for costs incurred prior to date of tender).

3. Requirement of a Tender of the Defense

The final pre-condition to an insurer’s duty to defend, is the insured’s tender of the defense of the underlying action to the insurer.

a. *What Constitutes A “Tender”*

In most case, an insured’s letter to its insurer will explicitly request a defense. In other cases, however, the notice may be explicitly described as merely “precautionary” or may be vague in terms of what is being requested. This vagueness may sometimes reflect the insured’s lack of sophistication or may sometimes mirror the complexity of policies that are written excess of self-insured retentions for which the insured is responsible for defense costs and the like.

A number of courts continue to hold to the view that an insured must explicitly request a defense in order for the letter to constitute a ‘tender.’ See, e.g. Litton Systems, Inc. v. Shaw’s Sales and Services, Ltd., 579 P.2d 48, 52 (Ariz. App. 1978)(Insured’s notice must “contain full and fair information concerning the pending action and an unequivocal certain and explicit demand to undertake the defense thereof”); and Unigard Insurance Company v. Leven, 983 P.2d 1155, 1160 (Wash. App. 1999), rev. denied, 999 P.2d 1263 (Wash. 2000)(“Insured must affirmatively inform the insurer that its participation is required).

In a growing number of states, however, courts have ruled that any form of notice to the insurer is sufficient to constitute a “tender” unless the insured expressly states that no defense is being sought or otherwise acts in a manner inconsistent with an intent to seek a defense. See Cincinnati Companies v. West American Insurance

Company, 701 N.E.2d 499, 504 (Ill. 1998)(“the better rule is one which allows actual notice of a claim to trigger the insurer’s duty to defend, irrespective of the level of the insured’s sophistication, except where the insured has knowingly foregone the insurer’s assistance); Cobb v. Empire Fire and Marine Insurance Company, 488 So.2d 349, 350 (La. Ct. App. 1986); White Mountain Construction Company v. Transamerica Insurance Company, 631 A.2d 907, 910 (N.H. 1993)(“in order for an insured to tender the defense to the insurer, it need only put the insurer on notice of the claim”) Widener University v. Fred S. James & Co., 537 A.2d 829, 833 (Pa. App. 1988) ; and Towne Realty, Inc. v. Zurich Insurance Company, 548 N.W.2d 64, 67 (Wis. 1996)(“tender of defense occurs once an insurer has been put on notice of a claim against the insured”).

In the most recent case to consider this issue, the Minnesota Supreme Court ruled in Home Insurance Company v. National Union Fire Insurance Company of Pittsburgh, C1-01-1429 (Minn. February 20, 2003) that sound public policy does not support a rule that requires insureds to expressly request a defense in order to trigger the duty to defend. The court ruled that the insured’s ignorance with respect to the particular language that it must use to invoke its right to a defense should not negate the insurer’s contractual duties. Further, it found that public policy supported requiring an insurer to promptly undertake its insured’s defense or begin an action for declaratory relief so as to promptly resolve coverage disputes. It concluded that, “once an insurer receives notice of the suit, it is responsible for defending the insured unless the insured explicitly refuses the insurer an opportunity to defend.” The court ruled that, “once notice is given, even without an express request for a defense, it should be the responsibility of the insurer to contact the insured to determine whether the insurer’s assistance in the suit is required.”

b. Are Pre-Tender Costs Recoverable?

Whether characterized as a formal request for a defense or mere notice of a claim, most courts have ruled that the defense obligation does not arise until a claim for coverage is tendered to the insurer. As a result, the majority view is that an insured cannot recover for defense costs incurred prior to the date of tender. See, e.g. Lafarge Corp. v. Hartford Cas. Ins. Co., 61 F.3d 389 (5th Cir. 1995); Litton Systems, Inc. v. Shaw's Sales & Services, Ltd., 579 P.2d 48, 52 (Ariz. App. 1978); Tradewinds Escrow, Inc. v. Truck Ins. Exch., 97 Cal.App.4th 704, 118 Cal.Rptr.2d 561 (2002); Reliance Ins. Co. v. County Line Place, 692 F.Supp. 694, 698 (S.D. Miss. 1988); Sentinel American Ins. Co. v. Aetna Cas. & Sur. Co., 876 P.2d 1314 (Haw. 1994); Cellex Biosciences, Inc. v. St. Paul Fire & Marine Ins. Co., 537 N.W.2d 621 (Minn. App. 1995); Sucrest Corp. v. Fisher Governor Co., 371 N.Y.S.2d 927, 941 (A.D. 1975); William C. Vick Construction Company v. Pennsylvania National Mutual Casualty Insurance Company, 1999 WL 412328 (E.D.N.C. March 24, 1999); Oregon Ins. Guaranty Assoc. v. Thompson, 760 P.2d 890 (Or. App. 1988); Widener University v. Fred S. James & Co., 537 A.2d 829, 833 (Pa. App. 1988); Nagel v. Kentucky Central Ins. Co., 894 S.W.2d 19 (Tex. App. 1994)(rejecting "quantum meruit" argument) and Unigard Insurance Company v. Leven, 983 P.2d 1155 (Wash. App. 1999). But see Gopher Oil Co. v. American Hardware Mutual Ins. Co., 588 N.W.2d 756 (Minn. App. 1999)(pre-tender costs recoverable in the event of insurer’s bad faith).

On the other hand, the Maryland Court of Appeals ruled in Sherwood Brands, Inc. v. Hartford Accident & Indemnity Co., 347 Md. 32, A.2d 1978 (1997) that an insurer may still be obligated to reimburse its policyholder for pre-notice costs unless it can show prejudice as a result of the delay in tender. The court ruled that the duty arises at the date of the original suit but that no claim for breach may exist until such time as the insurer is made aware of her claim.

While such cases seem to treat the tender requirement as a function of the notice obligations set forth in Condition 4 of the CGL policy, it is more properly viewed as part of the contractual prerequisites to the duty to defend. Accordingly, it is not subject to the rule of prejudice that applies in many jurisdictions to late notice disputes. Unlike the issue of late notice, moreover, an insured's delay in tendering a case only impacts upon its right to obtain reimbursement whereas fatally-delayed notice of a suit that is found to be in breach of Condition 4(b) of the policy may result in the insured losing all rights to coverage, including the insurer's prospective obligation to pay defense costs and indemnity.

Such costs may more properly be characterized as being akin to that portion of the cooperation clause (Condition 4(c)) that admonishes a policyholder not to voluntarily make payments or assume liabilities without the consent of the insurer. Indeed, some courts have barred recovery of pre-tender costs on the basis of Condition 4(c). See, e.g. . Palmer v. Truck Ins. Exchange, 66 Cal. App.4th 916 (1998); Tradewinds Escrow, Inc. v. Truck Ins. Exch., 97 Cal.App.4th 704, 118 Cal.Rptr.2d 561 (2002)(insurer had no obligation to reimburse pre-tender defense fees) and Northern Ins. Co. v. Allied Mut. Ins. Co., 955 F.2d 1353, 1360 (9th Cir. 1992).

II. MEASURING THE DUTY TO DEFEND

Traditionally, courts held that the duty to defend was based solely on the "four corners of the complaint." While that test remains the rule in a substantial number of states, most states now require insurers to also consider extrinsic facts of one sort or another. No uniform rule has emerged to govern the use of extrinsic facts, however. Whereas some courts only allow the consideration of extrinsic evidence to expand coverage or to fill in gaps where the underlying pleadings are silent, a few also sanction their use to defeat coverage or to contradict express allegations in the suit. Finally, courts have differed with respect to whether insurers have an affirmative obligation to seek out coverage-creating facts or must merely consider facts that are actually known to them or which are presented to them by policyholders.

A. The "Four Corners" Test

The traditional view was that an insurer need only consider the allegations set forth within the "four corners" of the complaint. Put differently, the insurer may not consider facts that are not alleged in the complaint. If one or more of the underlying claims would trigger the insurer's duty to indemnify if proved to be true, the insurer had

a duty to defend. This is consistent with the wording in the insuring agreement which first sets forth the duty to indemnify and then states that the insurer will defend “such” suits.

The “four corners” test is alive and well in several major states, notably New York and Texas (where for reasons known only to Texans, it is called “the eight corners test”). National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc., 939 S.W.2d 139, 141 (Tex. 1997) and Fitzpatrick v. American Honda, 78 N.Y.2d 61, 575 N.E.2d 90 (1991)(“the courts of this State have refused to permit insurers to look beyond the complaint’s allegations to avoid their obligation to defend”).

B. Beyond The “Four Corners” Test

Outside of these jurisdictions, a growing number of states are requiring insurers to look beyond the four corners of the pleadings to also consider certain extrinsic facts. These courts have declared that the insured’s right to a defense should not depend on the whim of plaintiff’s counsel’s choice of terms, notwithstanding the fact that tort claimants are more likely to overdraft complaints in an effort to create insurance coverage for defendants and only rarely vindictively limit their pleadings in an effort to preclude any possibility of coverage.

In general, the use of extrinsic facts arises in three separate situations: (1) to supplement pleadings that are otherwise silent on key coverage questions, whether to create or defeat a duty to defend; (2) to create a duty to defend by contradicting allegations that are not covered or (3) to defeat coverage by contradicting allegations that would otherwise give rise to a duty to defend.

1. Supplementing Pleadings: Filling In The Gaps

Except in “four corners” states, an insurer will be obligated to defend if facts are made known to it that, had they been alleged, would have triggered a duty to defend. This is particularly true where the complaint is silent with respect to a crucial fact on which coverage depends but which is irrelevant to the tort liability of the insured. For instance, the underlying complaint may not provide information that an insurer requires in order to assess when the plaintiff suffered bodily injury. If uncontradicted facts are readily available through other sources, they may also be taken into account in considering whether the insurer’s obligations are triggered.

Thus, a growing number of courts have ruled that an insurer cannot ignore facts that are known to it that, had they been pleaded, would have triggered its duty to defend. See SL Industries, Inc. v. American Motorist Ins. Co., 128 N.J. 188, 607 A.2d 1266 (1992)(insurer cannot hide behind a “formal fortress” of pleadings where it is aware of “true but unpleaded facts” requiring coverage).

2. Contradicting Pleadings To Create Coverage

A few courts have gone further, declaring that even where the allegations set forth in the underlying complaint expressly show that the plaintiff’s claims are not

covered, the insured may submit evidence demonstrating that, in fact, a potential for coverage does exist.

3. Contradicting Pleadings To Defeat Coverage

Finally, a handful of states permit insurers to rely upon extrinsic evidence to refute express allegations in a complaint that otherwise provide a basis for coverage.

One such jurisdiction is California. In Montrose Chemical Corporation v. Canadian Universal Ins. Co., 6 Cal. 4th 287, 861 P.2d 1153 (1993), the state Supreme Court ruled that a potential for coverage exists if there are express allegations in a complaint supporting a claim for coverage or if the complaint is completely silent with respect to coverage-related matters. Further, even if the complaint only alleges facts demonstrating an absence of coverage, the insurer cannot refuse to provide a defense if there are unpleaded facts that would support coverage. Accordingly, an insurer may only refuse to provide a defense if its own investigation determines that there is, in fact, no possibility of coverage.

Courts are most likely to allow insurers to look to extrinsic facts where they do not so much contradict pleaded facts as refute blanket allegations of negligence that are unsupported by factual statements. As will be discussed in a later section, theories of liability and headings in pleadings are not “facts.”

Facts may become “indisputable” by operation of collateral estoppel, especially in cases where the insured’s intent to injure may be incontrovertibly inferred based on a criminal conviction arising out of the same offense.

For instance, the Ohio Supreme Court ruled in Preferred Risk Ins. Co. v. Gill, 507 N.E.2d 1118 (Ohio 1987) that an insurer had no duty to defend a wrongful death suit, notwithstanding allegations of negligence on the part of its insured, where the insured had already been tried and convicted for murder.

Similarly, in Ohio Casualty Co. v. Clark, 583 N.W.2d 377 (N.D. 1998), the North Dakota Supreme Court ruled that a homeowner’s carrier was not bound to defend a wrongful death claim, notwithstanding allegations that the insured had acted “carelessly and negligently,” in view of the fact that the insured had been found guilty of manslaughter. Under such circumstances, the court ruled that it was appropriate to look to the actual facts. See also Burns v. UAC, 765 P.2d 712 (Mont. 1988)(allegation of negligence in assault case did not require defense where actual facts were that insured had intentionally struck plaintiff).

III. DO INSURERS HAVE A DUTY TO INVESTIGATE?

Courts have reached different conclusions with respect to the level of activity that an insurer must exercise in obtaining or reviewing extrinsic facts. Certainly such facts as an insured may communicate must be considered. Many courts have gone further, declaring that the insurer is obligated to take into account such facts as are actually known to it or which might be reasonably knowable. Only a handful of states have ruled that an insurer has an affirmative duty to investigate. Even in such cases, the duty to investigate is a reasonable one and does not require a scorched earth review.

As discussed in Section II, those courts that have abandoned a strict "four corners" test have generally required that insurers also consider facts that are "known or readily knowable." "Readily knowable" suggests that some form of investigation may be required. But what kind of investigation must be undertaken and how thorough a one is required?

In a few states, notably California, insurance regulations mandate the sort of investigation that must be undertaken. Outside of these jurisdictions, the case law sets forth vague principles that may be of little practical guidance.

For instance, in Alaska, the state supreme court has ruled that facts that are "readily knowable" are those that can be acquired through a reasonable investigation of the circumstances giving rise to the claim. National Indemnity Company v. Flesher, 469 P.2d 360 (Alaska 1970). In Montana, an insurer must "investigate and ascertain the relevant facts from all available sources." Mapes Industries, Inc. v. USF&G, 560 N.W.2d 874 (Neb. 1997). In West Virginia, the state supreme court declared in Farmer & Mechanics Mut. Ins. Co. v. Hutzler, 447 S.E.2d 22 (W. Va. 1994), that an insurer must undertake a "reasonable inquiry into the facts."

Very few courts have ruled that insurers have an affirmative obligation to conduct an investigation in all cases. Indeed, several have ruled there is no duty to investigate at all. See Valley Improvement Association, Inc. v. USF&G, 129 F.3d 1108 (10th Cir.1997)(New Mexico) and National Farmers Union Property & Cas. Co. v. Chuvash, 452 N.W.2d 307 (N.D. 1990).

For the most part, cases finding a duty to investigate arise in situations where the facts alleged against the insured are not enough to trigger a duty to defend but do suggest some need for further inquiry. Perkins v. Hartford Ins. Group, 932 F.2d 1392 (11th Cir. 1991)(Alabama law) and Colonial Oil v. Certain Underwriters at London, 258 Ga. 561, 562 (1997).

In Washington, insurers have been declared to have an independent obligation to investigate claims to determine whether facts exist that might support coverage. E-Z Loader Boat Trailers v. Travelers Ind. Co., 726 P.2d 439 (Wash. 1986). However, an insurer should only look beyond the allegation of the complaint if (1) the allegations are in conflict with facts that are already known or readily ascertainable by the insurer or (2) the allegations are ambiguous or inadequate to determine the availability of coverage.

Globe Indem. Co. v. First American State Bank, 720 F.Supp. 853, 858 (W.D. Wash. 1989).

Alternatively, some courts have found that an insurer must conduct at least enough of an investigation to independently evaluate such extrinsic evidence as its insured may submit. Thus, the Arizona Court of Appeals ruled in USF&G v. Advance Roofing & Supply Co., 788 P.2d 1227 (Ariz. App. 1989), rev. denied (Ariz. 1989) that if an insured comes forward with extrinsic facts establishing a potential for coverage, the insurer must conduct its own investigation to see whether coverage is warranted.

IV. WHAT CREATES A “POTENTIAL” FOR COVERAGE

It is black letter law in most states that an insurer has a duty to defend any suit for which there is a “potential for coverage.”? Yet, like many truisms, this statement provides little guidance. What exactly does it mean for there to be a “potential for coverage”?

A. There Must Be A Potential Indemnity Obligation

The duty to defend is broader than the duty to indemnify. Whereas an insurer’s duty to pay damages on behalf of its insured requires proof that the insured’s liability rests on a judgment or other proven facts within the scope of its coverage, only factual allegations creating a *potential* for coverage are needed to trigger a duty to defend.

In order for there to be a “potential for coverage,” the facts alleged must give rise to the possibility that the insurer will owe indemnity in the event that its insured is found liable to the plaintiff. Put differently, an insurer’s duty to defend arises whenever a complaint alleges facts which, if proven to be true, would create liability within the scope of the insurer’s coverage. Greer v. Northwestern National Ins. Co., 743 P.2d 1244 (Wash. 1987).

Conversely, there is no duty to defend if the facts alleged could not support any award of damages against the insured for which the insurer would owe indemnity. Allstate Ins. Co. v. Zak, 78 N.Y.2d 41, 574 N.E.2d 1035, 1037 (1991). See also Fire Ins. Exchange v. Abbott, 294 Cal. App.3d 1012, 1026, 251 Cal. Rptr. 620, 629 (1988), rev. den. (Cal. 1988); Mutual Service Co. v. McGehee, 711 P.2d 826 (Mont. 1985); Garneau v. Curtis & Bedell, Inc., 610 A.2d 132 (Vt. 1992). But see Farmers Texas County Mutual Ins. Co. v. Griffin, 955 S.W.2d 81, 82 (Tex. 1997)(there may be an obligation to defend even if there is no indemnity obligation).

This general rule should not be applied too literally, however. For instance, the frivolous or unfounded nature of the plaintiff’s theory of liability may preclude any chance of the insured being held liable. The consequent absence of any indemnity obligation is not a basis for an insurer refusing to defend such cases, however. See Penn-America Ins. Co. v. Disabled American Vets, Inc., 490 S.E.2d 129 (Ga. 1997); Ellis v. Transcontinental Ins. Co., 629 So.2d 365 (La. App. 1993); Maine Bonding &

Cas. Co. v. Douglas Dynamics, 594 A.2d 1079 (Me. 1991). See also Travelers Ind. Co. of Illinois v. INA, 94-0317 (S.D. Cal. May 10, 1995)(allegations of emotional distress triggered coverage as a "bodily injury" even though such damages may not be awarded in an action for damage to property). In short, the *legal* impossibility of indemnity does not preclude there being a duty to defend insofar as the factual allegations set forth a potential for coverage.

B. Factual Allegations Control, Not Theories of Liability

In considering whether there is a "potential for coverage," courts should consider the factual allegations set forth against the insured, not the "legal theory" or descriptions through which the plaintiff seeks to impose liability. What is important is the facts alleged: "the legal nomenclature the plaintiff uses to frame the suit is relatively unimportant." Pennsylvania Millers Mut. Ins. Co. v. Doe, 882 F.Supp. 195, 198 (D.N.H. 1994); Michaelian v. State Compensation Ins. Fund, 50 Cal. App. 4th 1093 (1996); Employers Mutual Ins. Co. v. Cedar Rapids Television Co., 552 N.W.2d 639, 642 (Iowa 1996); Mutual Benefit Ins. Co. v. Haver, 725 A.2d 743 (Pa.1999) (negligence claim does not trigger duty to defend, where factual allegations established intent to endanger); Farmers Texas County Mutual Ins. Co. v. Griffin, 955 S.W.2d 81 (Tex. 1997). See also Paradigm Ins. Co. v. Texas Richmond Corp. d/b/a The Mens Club of Houston, 942 S.W.2d 645 (Tx. App. 1997)(allegations based on negligent hiring or supervision did not trigger duty to defend where actual cause of plaintiff's injuries was excluded).

Thus, New York courts have refused to find a duty to defend based upon conclusory allegations that the insured "negligently" committed a forcible sexual assault. Greenberg v. National Chiropractic Mutual Ins. Co., 1996 U.S. Dist LEXIS 9179 (S.D.N.Y. July 3, 1996); Allstate Ins. Co. v. Mugavero, 79 N.Y.2d 153, 162, 589 N.E.2d 365 (1992); Peerless Ins. Co. v. Viegas, 667 A.2d 785 (R.I. 1995)(in case of child molestation, "the fact that the allegations in the complaint are described in terms of negligence is of no consequence")

In short, the mere recitation of "negligence" is not a talisman for coverage. See, e.g. USAA Property & Cas. Co. v. Rowland, 435 S.E.2d 879 (S.C. App. 1993)(inclusion of "negligence" claim didn't trigger duty to defend where it was mere "surplusage" and was used in the conduct of an act that can only be committed intentionally). More is required than including broad legal headings. It is the factual allegations themselves that matter.

This focus on factual allegations rather than theories of liability may sometimes create a duty to defend where a superficial review of the complaint does not reveal a basis for coverage. however. Many courts have found a duty to defend where the facts alleged could support recovery on the basis of a covered cause of action, even if that specific cause of action is not explicitly pleaded. For instance, the Supreme Judicial Court of Massachusetts ruled in Boston Symphony Orchestra, Inc. v. Commercial Union Ins. Co., 406 Mass. 7, 10 (1989) that Commercial Union was obliged to defend the Boston Symphony against Vanessa Redgrave's suit for breach of contract because the

complaint made reference to defamatory public statements by the BSO. The CU policy did not cover breach of contract claims but did cover “defamation” under its Personal Injury section. The Massachusetts court ruled that even though the complaint did not contain any count for “defamation” as such, CU had a duty to defend because the facts could support an award of damages for defamation.

On the other hand, there must be actual existing allegations in the complaint in order to trigger coverage. The mere possibility that such allegations could later be asserted has generally been found insufficient to give rise to a duty to defend. . In New England Tea and Coffee Company v. Fireman’s Fund Ins. Co., 54 Mass. App. Ct. 903, 763 N.E.2d 103 (2002), the SJC’s holding in Boston Symphony Orchestra, noting that the “other defamatory or disparaging material” language that the BSO court had relied on was not contained in Fireman’s Fund’s policy particularly as, in this case, there was no public statement by the insured regarding the plaintiff’s termination that might arguably trigger this portion of the policy.

More recently, in Open Software Foundation, Inc. v. USF&G, 307 F.3d 11 (1st Cir. 2002), the First Circuit rejected an insured’s claim that an insurer must defend in any case where the plaintiff could have sued for a covered personal or advertising injury on the basis of facts that were not pleaded in the complaints but that were known or readily knowable by the insurer at the time. The court noted that extrinsic facts can sometimes “be misused by insureds seeking to transform a skeletal claim in the underlying complaint into an allegation arguably covered by the liability policy but unrelated to an actual claim in the complaint.” The First Circuit ruled that extrinsic facts should be used “to aid interpretation of the Complaint, and not as independent factual predicates for a duty to defend.”

C. Insurer Must Defend Even If Claims Are Groundless

Most general liability policies contain language stating that the insurer will defend a suit, even if the allegations against the insured are later shown to be “false, groundless or fraudulent.” In short, an insurer cannot avoid a duty to defend merely because it does not believe the facts communicated by its insured. Amato v. Mercury Cas. Co., 18 Cal. App.4th 1784, 23 Cal. Rptr.2d 73 (1993).

As noted by the California Supreme Court in its seminal ruling in Gray v. Zurich Ins. Co., 65 Cal.2d 263, 274 (1966), the “groundless, false or fraudulent” clause does not extend the obligation to defend without limits; it includes only defense to those actions of the nature and kind covered by the policy.”

If facts are alleged that create a potential for coverage, an insurer may not disclaim its duty to defend based on a unilateral conclusion that the coverage-creating allegations are not truthful. On the other hand, this clause does not require an insurer to disregard explicit allegations in a law suit that rule out any possibility of coverage merely because the insured contends that these factual allegations are not truthful. Hecla Mining v. New Hampshire Ins. Co., 811 P.2d 1083 (Col. 1991)(a “potential for

coverage” is not created merely because the insured denies the truth of the claims against it).

As above, in order for there to be a duty to defend, there must be the possibility that the insured can be liable to the plaintiff on the basis of a covered set of facts. Accordingly, if the insured is sued for a murder that he denies committing, there is no duty to defend as there is no possible set of facts upon which the insured could be liable to the plaintiff that would give rise to an indemnity obligation. This is to be contrasted with a case in which the insured is sued for wrongful death but asserts that he killed in self-defense or somehow lacked an intent to cause injury.

This point is ably illustrated by Quan v. Truck Ins. Exchange, 67 Cal. App.4th 583, 79 Cal. Rptr.2d 134 (2nd Dist. 1998). Quan was accused of sexually assaulting the plaintiff, which accusation he denied. In affirming the lower court’s ruling that Truck had no duty to defend, the Second District explained that the point of the insurer’s promise to defend suits even if “false, groundless or fraudulent” is that an insurer may not rid itself of the burden of defending an action that seeks damages potentially falling within the scope of the policy’s coverage merely by arguing that the suit has no merit. The “groundless or false” clause does not change the fundamental principle that there is no defense obligation absent potential liability under the policy.” If Quan had committed the assault, Truck would have no indemnity obligation since such acts were not an “occurrence” under its policy. Alternatively, if Quan was innocent, as he claimed, there could be no indemnity obligation. As there was no scenario whereby Quan could be liable to the plaintiff on a factual basis that would fall within the scope of Truck’s coverage, there was no duty to defend.

V. EFFECT OF SUBSEQUENT EVENTS ON THE DUTY TO DEFEND

In preceding sections, we have discussed the tests that courts apply to measure whether a duty to defend exists and the sources of proof that will be considered in measuring this obligation. An issue that often arises, however, is how those duties are addressed in cases where no duty exists at the outset but further facts or claims subsequently emerge that the insured contends may warrant coverage. Does the insurer have a continuing obligation to monitor the litigation to determine if a potential for coverage emerges? Alternatively, is the mere possibility that such facts could later emerge sufficient in and of itself to create a duty to defend from the outset?

In general, an insurer’s duty to defend is determined based on the facts pleaded (or, where permitted, the facts known or knowable) at the time that the defense is tendered. Conversely, an insurer cannot be held responsible for later-developed facts of which it was unaware at the time of tender. Great American Ins. Co. v. McKemie, 259 S.E.2d 39, 40 (Ga. 1979). As a result, most courts have ruled that it is the insured’s responsibility to bring such facts to the insurer’s attention, along with amendments to the pleadings or other developments that might implicate coverage.

If an amended complaint has been filed, it is this most recent pleading that should be considered in assessing whether the insurer has a duty to defend. Rhodes v.

Chicago Ins. Co., 719 F.2d 116, 120 (5th Cir. 1983) (Texas law). This rule can sometimes preclude coverage if the factual basis for claiming coverage has been eliminated before the case is tendered to the insurer. See Pedro Companies v. Sentry Ins. Co., 518 N.W.2d 49 (Minn. App. 1994)(insurer had no duty to defend where those aspects of the plaintiff's claim that might have triggered coverage were dismissed prior to the date that the defense was tendered to the insurer).

A. Does The Possibility Of Future Amendments Trigger Coverage?

If the present pleadings fail to state a covered claim, does an insurer still have a duty to defend if it is aware of facts that might support an amended complaint adding a covered claim?

As discussed in preceding sections, the resolution of this question depends to a large extent on whether the jurisdiction follows a strict "four corners" test. If not, an insurer's awareness of actual facts creating a potential for coverage may trigger a duty to defend, even if those facts are not expressly pleaded in the underlying complaint.

On the other hand, a duty to defend may not be manufactured by the insured's speculation about unpleaded third-party claims. Quan v. Truck Ins. Exchange, 67 Cal. App.4th 583, 79 Cal. Rptr.2d 134 (2nd Dist. 1998)(insured's denial that he committed crime does not create coverage for criminal acts) and Michaelian v. State Compensation Ins. Fund, 50 Cal. App. 4th 1093, 1106 (1996).

Nevertheless, a federal district court in Pennsylvania declared in Safeguard Scientifics, Inc. v. Liberty Mut. Ins. Co., 766 F.Supp. 324 (E.D. Pa. 1991), rev'd in part on other grounds, 961 F.2d 209 (3d Cir. 1992), that a duty to defend exists, even if the suit does not presently allege any covered claim, if the facts already alleged in the underlying suit could reasonably be amended to assert a covered claim. However, the Safeguard approach has not been widely followed. See, I.C.D. Industries, Inc. v. Federal Ins. Co., 879 F.Supp. 480 (E.D. Pa. 1995)(mere possibility that action for patent infringement could later be amended to plead a covered cause of action for unfair competition does not give rise to duty to defend in the interim).

In general, therefore, the rule is that insurers are only required to consider the allegations and facts as they exist at the date of tender. To the extent that new facts or claims later emerge, the insured should re-tender the claim for reconsideration.

B. Effect of Amended Complaints Or Later Developed Facts

If the facts and pleadings presented to the insurer at the time of its initial coverage determination clearly showed no potential for coverage, the insurer has no obligation to continue to monitor developments and discovery in the case. Gunderson v. Fire Ins. Exchange, 37 Cal. App.4th 1106, 44 Cal. Rptr.2d 272 (1995) and Leader National Ins. Co. v. Smith, 339 S.E.2d 321, 327 (Ga. App. 1986). If new facts appear supporting their claim, the insured has a duty to re-tender the claim for coverage.

In Scopel v. Donegal Mut. Ins. Co., 698 A.2d 602 (Pa. Super.1997), the intermediate appellate court of Pennsylvania ruled that an insurer does not have a continuing obligation to monitor pre-trial discovery to determine if facts had emerged that would change its no coverage position. The Superior Court ruled that "the rightful denial of coverage based upon a filed complaint should relieve an insurer of the duty and burden of tracking the developments in a case in which the insurer has no legal interest." Rather than requiring the insurer to continue to monitor pre-trial developments, the court ruled that the better-reasoned approach would be to require the underlying plaintiff who wishes to assert a new theory of liability premised on newly discovered evidence to file an amended complaint setting forth any new claims

Amendments to the pleadings should only trigger the insurer's duty to defend prospectively. As a result, the insurer only has a duty to pay defense from the point in time when the amended complaint was re-tendered to it. First Bank of Turley v. Fidelity & Deposit Co. of Maryland, 928 P.2d 298 (Okla. 1996); SL Industries, Inc. v. American Motorist Ins. Co., 128 N.J. 188, 607 A.2d 1266 (1992); Hagen v. Aetna Casualty & Surety Co., 675 So.2d 963 (Fla. DCA5 1996) and Scopel v. Donegal Mut. Ins. Co., 698 A.2d 602 (Pa. Super. 1997). The addition of the covered claim does not require the insurer to retroactively reimburse the insured for defense costs up to that point.

VI. WHAT IS A "COST OF DEFENSE"?

Assuming that an insurer is declared to have a duty to defend, what are the "defense costs" that must be paid?

It might be assumed that determining what constitutes a "cost of defense" would be self-evident in most cases. In fact, the reality is more complex. In particular, insurers are often confronted with demands that they not only pay for defense counsel but must also reimburse policyholders for sums attributable to in-house counsel, public relations consultants and other personnel who are alleged to have been an integral part of the "defense team." Additionally, in large complex cases, issues may arise with respect to the obligation to pay for national coordinating counsel. See Dow Corning Corp. v. Hartford Accident & Ind. Co., Wayne No. 93-525788-K (Mich. Cir. Ct. February 27, 1996), aff'd in part, rev'd in part, No. 200143 (Mich. App. October 12, 1999) (holding that insurers must pay for national coordinating counsel due to size and complexity of underlying breast implant litigation).

1. In House Counsel

Most liability policies expressly state that insurers have no obligation to reimburse a policyholder for its own costs or overhead (except to the limited extent provided for under the Supplemental Payments provisions and only then when the costs are incurred at the insurer's request). In Dow Corning, Judge Columbo ruled that insurers whose policies excluded "salaries of the assured" did not have to pay for benefits and salary attributable to in-house counsel. Nevertheless, some courts have ruled that in-house counsel's fees may be reimbursable where the work in question was necessary to the defense effort and would otherwise have been carried out by outside

counsel, presumably at a higher cost. Pittsburgh Plate Glass Co. v. Fidelity & Cas. Co. 281 F.2d 538, 542 (3d Cir. 1962) and Travelers Ins. Co. v. State Ins. Fund, 588 N.Y.S.2d 973 (N.Y. Ct. Cl. 1992), aff'd, 642 N.Y.S.2d 867, 227 A.D.2d 208 (1996).

Yet how are such “fees” to be calculated? In an analogous context, a federal district court in Massachusetts ruled that time spent by a client’s general counsel in assisting outside counsel was not recoverable as part of a fee award under the Massachusetts Consumer Protection Act (MGL Chapter 93A) as counsel was an employee and the hours billed and rate that would be assessed to such time was speculative and undocumented. A.D. Little v. Dooyang Corp., 985 F. Supp. 217 (D. Mass. 1998).

On the other hand, the California Court of Appeal ruled in PLCM Group, Inc. v. Drexler, 72 Cal. App.4th 693, 84 Cal. Rptr.2d 905 (1999) that a professional malpractice policy that provided that the insurer was entitled to its attorney’s fees and costs if it was compelled to sue a policyholder for reimbursement of the policy deductible, the insurer was not prohibited from recovering attorney’s fees by reason of the fact that it utilized in-house counsel. In rejecting the defendant’s contention that such fees were not “incurred” for purposes of Section 1717 of the California Civil Code because there was no evidence that the insurer had actually paid them, the Second District declared that the amount of the fees should be computed in accordance with reasonable market rates for outside counsel.

2. Public Relations Consultants

Controversy also exists with respect to the extent to which the duty to defend extends to fees incurred by public relations consultants or other non-attorney members of the “defense team.” Insureds argue in large or complex cases that it is naïve to assume that the defense of such cases merely requires the deployment of attorneys and that the involvement of public relations firm is a necessary out of court adjunct to the defense work that is going on inside the courtroom.

In Hercules Inc. v. Aetna Casualty & Surety Co., No. 92C-10-105 (Del. Super. Ct. January 14, 1998), a Delaware trial court declined to grant summary judgment to an insured with respect to whether it could recover public relations costs. Judge Silverman ruled that there were issues of fact as to whether certain salaries of the insured's employees should be covered. The court also refused to find that public relations expenses were covered as there was no evidence that these expenditures enhanced the insured's litigation exposure, nor did they deal directly with property damage.

On the other hand, fees incurred by public relations consultants to help the insured counteract negative publicity were held not to be covered despite policyholder arguments that PR firms are an essential aspect of a broad-based defense to mass tort litigation. See Arco Industries, Inc. v. American Motorists Ins. Co., Kalamazoo No. A 87-0218-CK (Mich. Cir. Ct. July 11, 1989)(pollution claims) and Broadhead v. Hartford, 773 F.Supp. 882 (S.D. Miss. 1991)(gas well blow outs).

Future litigation on this issue is also likely to be impacted by pollution coverage cases in which courts have taken a very expansive view of what constitutes a “defense cost.” For instance, the California Supreme Court ruled in Aerojet Chemical Corp. v. Transport Ind. Co., 948 P.2d 909 (Cal. 1997) that the cost of retaining engineering consultants and performing various site studies could be part of the insurer’s defense obligation if the costs (1) were incurred after the date of tender but before liability is adjudicated; (2) were reasonably and necessary in amount and (3) reasonably related to diminishing (as opposed to satisfying) the insured’s liability. Outside of California, some courts have resolved this issue by focusing on whether the tasks in question were in the nature of investigative costs that were incurred for the purpose of determining whether the insured was liable (and thus part of the “defense” of the case) or were in the nature of clean up or remedial measures that had the effect of satisfying the insured’s indemnity obligation. In other cases insurers and insureds have taken somewhat inconsistent positions depending on whether it was in the insured’s interest to have these costs treated as part of the defense obligation (as where the insured has relatively low indemnity limits) or where the insured wanted to use these costs to exhaust a small indemnity deductible to access excess limits.

As with these environmental cases, many of these cases in which these issues will be presented involve large corporate insureds with self-insured retentions or non-standard provisions for the payment of defense costs that may influence insureds to argue that certain categories of costs are part of the insured “loss” and not defense costs. Accordingly, care should be taken not to generalize about the likely positions that insureds will argue.

Nevertheless, to the extent that generalizations can be made, it appears that courts are less and less willing to apply fixed rules that clearly include or preclude these categories of costs, particularly absent clear and explicit policy limitations. Rather, courts seem inclined to take a flexible view of the duty to defend that may include unconventional types of “defense costs” that may be needed in some of these more complex cases.

VII. What Is The Scope of The Duty to Defend?

Apart from disputes concerning the type of “*defense costs*” that insurers are sometimes declared to owe, controversy persists concerning the type of *tasks* that may be found to fall within the scope of the duty to defend. In particular, do insurers have a duty to (1) pursue appeals; (2) defend counter-claims; or (3) prosecute third-party complaints against other culpable parties?

A. Appeals

To be sure, insurers often pay to appeal adverse verdicts where, in the judgment of the insurer, an appeal is merited. If the insurer does not believe that an appeal is appropriate, however, can the insured sue to enforce a “duty to appeal”?

Most insurance policies provide for the payment of appeal bonds as a Supplemental Payment. Nevertheless, policies say nothing about whether the insurer has an enforceable obligation to file an appeal.

Notwithstanding the absence of a clear expression in the policy, the rule in most states is that the duty to defend includes an obligation to appeal an adverse verdict so long as reasonable grounds for an appeal exist. City of West Haven v. Commercial Union Ins. Cos., 894 F.2d 540, 545 (2nd Cir. 1990)(Connecticut law); Ziebart International Corp. v. CNA Ins. Cos., 78 F.3d 245, 248 (6th Cir. 1996) (Michigan law); Cathay Mortuary v. United Pacific Ins. Co., 582 F.Supp. 650 (N.D. Cal. 1984); INA v. National American Ins. Co. of California, 37 Cal. App. 4th 195, 43 Cal. Rptr.2d 518 (4th Dist. 1995); Aetna Ins. Co. v. Borrell-Bigby Electric Co., 541 So.2d 129 (Fla. App.2dCA 1989); Glenn v. Flemming, 799 P.2d 78, 88 (Kan. 1990); Wilcox v. Board of Education, 779 S.W.2d 221, 223 (Ky. App. 1989); Reichert v. Continental Ins. Co., 290 So.2d 730, 734 (La. Ct. App. 1974); Aetna Cas. & Sur. Co. v. Sullivan, 597 N.E.2d 62 (Mass. App. Ct. 1992); Kaste v. Hartford Accident & Indemnity Co., 170 N.Y.S.2d 614, 5 A.D.2 203 (1958) and Truck Ins. Exchange v. Century Indemnity Group, 887 P.2d 455, 459 (Wash. App. 1995).

This may be true even where the trial court's verdict has resulted in a judgment that would exhaust the insurer's policy limits. In Jenkins v. INA, 272 Cal. Rptr. 7, 220 Cal. App.3d. 1481 (4th Dist. 1990), the California Court of Appeal ruled that an insurer could not terminate its defense duty by tendering its limits after an excess verdict against its insured, finding that the duty continued until the judgment became final and that the insurer therefore had a duty to take all reasonable steps to protect its insured's interests in the interim, including paying for an appeal.

The obligation to pursue an appeal may be extinguished where the verdict was entered on the basis of an uncovered claim even if a duty to defend originally existed because of covered claims that were not ultimately the basis for the insured's liability. Crist v. INA, 529 F.Supp. 601 (D. Utah. 1982).

As a practical matter, it is unlikely that many insurers will refuse to take an appeal from a case that has resulted in a verdict in excess of its policy limits since, whatever the appeal of cutting off further defense costs, the insurer may be facing claims of bad faith for its failure to settle the claim within limits.

B. Counter-Claims

It is not uncommon for defense claims to arise in the context of a suit that has been commenced by a policyholder that prompts a counter-claim back against the insured by the defendant. For instance, a landlord's suit to collect rent from a tenant may prompt a counter-suit by the tenant for mold damages or other problems attributable to a claimed breach of the implied covenant of habitability. Similarly, a lawyer's suit to recover fees from a client may result in a counter-claim for malpractice.

Plainly, the insurer would have had no duty to pay for the cost of prosecuting the original actions in these examples. So does the addition of a counter-claim give rise to a duty to defend and, if so, does the insurer then have a duty to pay all legal fees incurred in connection with the litigation as a whole?

The crucial question is not the procedural context in which the pleading arises. An insurer may have a duty to defend a tenant's counter-claim alleging lead poisoning even though it does not have a duty to pay for the cost of pursuing the complaint for back rent that prompted the counter-claim. Rather, the question is whether the pleading seeks damages because of an "occurrence" within the scope of coverage.

The mere assertion of affirmative defenses by a defendant in response to the plaintiff's suit does not trigger a duty to defend. As recognized by the California Court of Appeal, mere defenses to the insured's Complaint do not present any potential that the insured would be obligated to pay damages for which coverage would be afforded under the policy. 3250 Wilshire Boulevard Building v. Employers Insurance of Wausau, 39 Cal. App. 4th 1277, 46 Cal. Rptr. 2d 399 (2nd Dist. 1995).

In Construction Protective Services, Inc. v. TIG Specialty Ins. Co., S099647 (Cal. November 14, 2002), the California Supreme Court ruled that the Court of Appeal erred in finding that a defendant's inclusion of an affirmative defense for a statutory setoff claim under California Code of Civil Procedures Section 431.70 necessarily triggered an insurer's duty to defend. The Court of Appeal had ruled that the statutory setoff claim for the insured's negligent provision of security services triggered a duty to defend in a case where TIG's insured had originally sued the defendant for sums owed for security services at the site. The Supreme Court nevertheless affirmed the ruling of the Court of Appeal that the trial court should not have sustained the insurer's demurrer, concluding that a party may plead the legal effect of the contract rather than its precise language. The case was remanded to the lower court to evaluate whether TIG could sustain its arguments on summary judgment, as distinguished from the threshold demurrer considerations.

C. Third Party Claims

Alternatively, where the insured is named as a defendant in a suit that its insurer is defending, does the insurer's defense obligation extend to pursuing third party claims that will have the effect of reducing the insured's indemnity exposure.

While recognizing that "the best defense may be a good offense," the Wisconsin Supreme Court ruled in Towne Realty, Inc. v. Zurich Ins. Co., 548 N.W.2d 64 (Wis. 1996) that the cost of prosecuting various counterclaims were not covered defense costs. Likewise, the Appellate Court of Illinois ruled in International Insurance Company v. Rollprint Packaging Products, Inc., No. 1-98-2381(1st Dist. March 31, 2000) that whether or not a counterclaim was "integral to the insured's complete defense of the lawsuit," its prosecution was not a "defense" task.

Consistent with these cases, most courts have ruled that the insurer only has a “defense” obligation and is therefore not obligated to pursue counter-claim or other offensive” actions on behalf of its policyholder. St. Paul Fire & Marine Ins. Co. v. National Computer Systems, Inc., 490 N.W.2d 626, 632 (Minn. App. Ct. 1992); Goldberg v. American Home Assurance Company, A.D.2d 409, 439 N.Y.S.2d 2, 4 (1981); Reynolds v. Hartford Accident & Indemnity Company, 278 F. Supp. 331, 333 (S.D.N.Y. 1967); Duke University v. St. Paul Fire & Marine Ins. Co., 384 S.E.2d 36, 46 (N.C. App. 1989); Berlant v. McAllister, 480 P.2d 126, 127 (Utah 1977); and Shoshone First Bank v. Pacific Employers Insurance Company, 2 P.3d 510 (Wyo. 2000).

Some courts have suggested that this rule exalts form over substance, however, and that what should matter is whether the insured is in need of a defense. In Smart Style Industries, Inc. v. Pennsylvania General Ins. Co., 930 F.Supp. 159 (S.D.N.Y. 1996), a federal court ruled that a preemptive suit filed by the insured was subject to an insurer's duty to defend since it had been filed to clarify a claim against the insured and was in response to a threat by the defendant to sue it. Under the circumstances, the court ruled that the insured was actually in a "defensive" posture and thus entitled to a defense.

Other courts have also ruled that an insured may recover costs relating to “offensive” aspects of a lawsuit where they overlap defense costs. For instance, the Appellate Division ruled in Sucrest Corp. v. Fisher Governor Co., 371 N.Y.S.2d 927, 941 (A.D. 1975) that the cost of pursuing a third-party complaint was within the scope of the insurer's defense obligation as the same work was required that would have been undertaken in any event to defend the case.

By contrast, the Wisconsin Court of Appeals ruled in Sauk County v. Employers Ins. of Wausau, 550 N.W.2d 439 (Wis. App. 1996) that even though a counterclaim alleging that the plaintiff was itself liable for the subject matter of its claim was a "suit" that must be defended, Wausau had not breached any duty to defend by paying the arbitrary amount of one-sixth of the total costs of prosecuting the case where the insured's attorneys had refused to break out their time concerning the actual defense of the counterclaim.

VIII: Losing Control of the Defense--Conflicts of Interest

As discussed in Section I, the duty to defend is a valuable *right*. In consideration of the insurer's promise to defend, the insured has relinquished control over the defense of the case. As a consequence, the insurer has complete dominion over decisions with respect to how the case should be defended and/or settled or tried.

Yet this right can be forfeited in cases where coverage issues create a conflict of interests between the insured and its carrier. Chi of Alaska, Inc. v. Employers Reinsurance Corp., 844 P.2d 1113 (Alaska 1993); Farmers Ins. Co. v. Vagnozzi, 138 Ariz. 443, 675 P.2d 703 (1983); Maryland Cas. Co. v. Peppers, 355 N.E.2d 24, 31 (Ill. 1976); Patrons Mutual Ins. Assoc. v. Harmon, 732 P.2d 741 (Kan. 1987); Allstate Ins. Co. v. Campbell, 639 A.2d 652, 659 (Md. 1994); Prahm v. Rupp Construction Co., 277

N.W.2d 389, 391 (Minn. 1979); Moeller v. American Guaranty & Liability Ins. Co., 707 So.2d 1062 (Miss. 1996); American Employers Ins. Co. v. Crawford, 533 P.2d 1203, 1209 (N.M. 1975); 69th Street Garage Associates v. Ticor Title Guaranty Co., 622 N.Y.S.2d 13, 14 (App. Div. 1995); State Farm Fire & Casualty Co. v. Pildiner, 321 N.E.2d 600, 603 (Ohio 1974) and Lima v. Chambers, 657 P.2d 279, 285 (Utah 1982).

In these cases, courts have reasoned that an insured should not be forced to give up control of its own defense if the insurer, by raising coverage issues, has an incentive to handle the defense in a manner that supports the interest of the insurer but not the policyholder. Yet, courts have reached widely differing conclusions with respect to the circumstances under which a conflict will be found to give the insured the right to retain counsel of its own choosing.¹

The leading case addressing the rights of policyholders with the respect to the right to independent counsel in “conflicts” cases remains San Diego Federal Credit Union v. Cumis Ins. Society, 162 Cal. App.2d 358 (1984). Under the Cumis doctrine, later codified as California Civil Code Section 2860 (1996), an insured may select counsel in the event of a genuine conflict. However, the insurer need only pay the customary hourly rate for defense counsel and may require that the counsel selected by the insured possess certain minimum qualifications, including at least five years of civil litigation experience, including substantial defense experience in the subject at issue in the litigation as well as malpractice coverage.

Section 2860 provides, in pertinent part:

(a) If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured

(b) For purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage; however, when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim, a conflict of interest may exist. No conflict of interest shall be deemed to exist as

¹ For a more detailed analysis of these issues and the case law that has emerged in specific jurisdictions, the reader is referred to the numerous law review articles that have been published on these issues, including : Douglas R. Richmond, *Liability Insurers’ Right to Defend their Insureds*, 35 Creighton L Rev. 115 (2001); Robert H. Jerry, II, *The Insurer’s Right to Reimbursement of Defense Costs*, 42 ARIZ. L. REV. 13 (2000); Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1 (1999); William T. Barker, *Insurance Defense Ethics and the Liability Insurance Bargain*, 4 CONN INS. L.J. 75 (1997-98).

to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

“As statutory and case law make clear, not every conflict of interest triggers an obligation on the part of the insurer to provide the insured with independent counsel at the insurer’s expense. For example, the mere fact the insurer disputes coverage does not entitle the insured to Cumis counsel; nor does the fact the complaint seeks punitive damages or damages in excess of policy limits. The insurer owes no duty to provide independent counsel in these situations because the Cumis rule is not based on insurance law but on the ethical duty of an attorney to avoid representing conflicting interests.” Golden Eagle Ins. Co. v. Foremost Ins. Co., 20 Cal.App.4th 1372, 1394 (1993). For independent counsel to be required, the conflict of interest must be “significant, not merely theoretical, actual, not merely potential.” Dynamic Concepts, Inc. v. Truck Ins. Exchange, 61 Cal. App.4th 999, 1007, 71 Cal. Rptr.2d 882 (1st Dist. 1998).

Likewise, California courts have ruled that Cumis counsel is not required, for instance, where the coverage issue is independent of, or extrinsic to, the issues in the underlying action. Native Sun Investment Group v. Ticor Title Ins. Co., 189 Cal. App. 3d 1265, 235 Cal. Rptr. 34 (1987). Nor is there entitlement where the damages are only partially covered by the policy or where some of the claims are covered and others are not. Dynamic Concepts, Inc. v. Truck Ins. Exchange, 61 Cal. App.4th 999, 71 Cal. Rptr.2d 882 (1st Dist. 1998)(assertion of right to recover Buss fees) and Foremost Ins. Co. v. Wilks, 206 Cal. App. 3d 251, 253 (1988) (punitive damages). Further, the conflict must be significant and actual, not merely theoretical or potential. Lehto v. Allstate Ins. Co., 31 Cal. App. 4th 60, 71, 36 Cal. Rptr. 2d 814 (1994).

However, independent counsel is required where there is a reservation of rights “and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim.” § 2860, subd. (b); Blanchard v. State Farm Fire & Casualty Co., 2 Cal.App.4th 345, 350 (1991); Truck Ins. Exchange v. Superior Court, 51 Cal.App.4th 985, 994 (1996)

While the Cumis doctrine has had a dramatic impact on the way in which courts in other states have addressed these issues, it has not been followed in every state

A few states have taken a broader view than Cumis and have concluded that all reservations of rights create a conflict of interest warranting the retention of independent counsel without regard to whether the coverage dispute is of such a nature that it could influence the manner in which the case is defended. See, e.g. Three Sons, Inc. v. Phoenix Ins. Co., 357 Mass. 271, 274 (1970).

Other courts have ruled that in the event of a conflict the insurer must allow the insured to select private counsel (paid by the insurer) who must be permitted to control the defense. See Sauer v. Home Indem. Co., 841 P.2d 176, 182-3 (Alaska 1992); Grube v. Daun, 496 N.W.2d 106, 123 (Wis. Ct. App. 1992).

Another approach is to give the insurer a choice to either employ independent counsel to control the defense or permit the insured to select private counsel (to be compensated by the insurer) to control the defense. See Michigan Millers Mut. Ins. Co. v. Bronson Plating Co., 496 N.W.2d 373, 378 (Mich. App. 1992) and L&S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co., 521 So.2d 1298, 1304 (Ala. 1987).

A second approach is to permit the insured to select counsel subject to the insurer's approval. See Employers Fire Ins. Co. v. Beals, 240 A.2d 397, 404 (R.I. 1968). Likewise, in states such as Florida, the insurer does not lose control of the selection of counsel in the event of a conflict but is required to appoint counsel that is acceptable to the policyholder.. Continental Ins. Co. v. Miami Beach, 520 S.2d 232, 233 (Fla. App. 1988)(Fl. St. 627.426(2) provides that insurer and insured should jointly select "mutually agreeable" counsel).

At the other end of the spectrum, a few states have declared that a liability insurer that is defending its insured under a reservation of rights has no obligation to pay for independent counsel for the insured. In Hawaii, for instance, the state supreme court reversed the findings of the Hawaii Court of Appeals, which had adopted a Cumis approach, and instead held in Finley v. Home Ins. Co., 975 P.2d 1145 (Hawaii 1998) that the best course of action is to avoid interfering with the insurer's contractual right to retain defense counsel and to leave the resolution of the conflict to the integrity and professional standards of conduct mandated for defense counsel

A few states have also declared that the insurer need not give up control of the defense but will thereafter be judged by a standard of "enhanced good faith." L&S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co., 521 So.2d 1298, 1304 (Ala. 1987); Ferguson v. Birmingham Fire Ins. Co., 460 P.2d 342, 348 (Or. 1969) and Tank v. State Farm Fire & Casualty Co., 715 P.2d 1133 (Wash. 1986)

Even in jurisdictions that follow the Cumis approach, not every reservation of rights entitles an insured to select its own counsel. A liability insurer has the right to appoint defense counsel, even where it has reserved its rights on one or more coverage issues, unless an actual conflict of interest exists that would permit the manipulation of evidence towards non-covered bases for liability. Mutual Service Cas. Ins. Co v. Luetmer, 474 N.W.2d 365 (Minn. App. 1991).

Under New York law, independent counsel is only required where a clear conflict of interest exists between the interests of the policyholder and the insurer, as where counsel's duty to the policyholder would require him to seek to dismiss the action on grounds that would affect the insurer's interests. Public Service Mutual Ins. Co. v. Goldfarb, 425 N.E.2d 810, 815 (N.Y. 1981).

The Oklahoma Court of Appeals has ruled that a liability insurer was obligated to pay for defense counsel of the insured's own choosing in an extreme cases where appointed defense counsel admitted to an ethical dilemma based upon the insurer's refusal to permit him to pursue a defense strategy that would have conflicted with the

insurer's reservation of rights in a sexual misconduct malpractice case. Nisson v. American Home Assurance Co., 917 P.2d 488 (Okl. App. 1996).

IX. What Are “Reasonable” Defense Costs

In cases where the insurer is required to pay for counsel of the insured's own choosing, the insurer typically not have a formal agreement with the lawyers representing the insured concerning hourly rates, billing procedures and the like. Is the insurer at counsel's mercy or are there still controls that the insurer may assert?

Although the insurer has lost the unilateral right to appoint defense counsel in these cases, it is not obligated to issue a blank check for defense costs. Controversy exists, however, with respect to the extent to which defense counsel must conform to the requirements that otherwise would have been imposed on panel defense counsel, either as regards the hourly rate for bill or reporting and litigation management tasks.

Most courts have found that, even where an insurer is required to pay for the use of outside counsel of the insured's choosing, said payment obligation is limited to “reasonable and necessary”: defense costs. Liberty Mutual Ins. Co. v. Continental Casualty Co., 771 F.2d 579 (1st Cir. 1985) and Sharon Steel Corp. v. Aetna Cas. & Sur. Co., 931 P.2d 127, 139 (Utah 1997).

In fact, an attorney is ethically obligated to only charge a “reasonable” fee. Rule 1.5 of the Model Rules of Professional Conduct provides that an attorney's fees shall be “reasonable.” As the Montana Supreme Court held In re Rules of Professional Conduct, 2 P.3d 806, 814 (Mont. 2000), even where defense counsel are not subject to strict litigation guidelines imposed by insurers, defense counsel do not have a “blank check” to escalate litigation costs or to charge insurers for what beyond what is reasonable and necessary.

The problem, of course, is defining what general terms such as “reasonable and necessary” mean in a particular case. In particular, should “reasonable and necessary” be construed in the context of what the insurer would ordinarily have paid its panel counsel for the defense of such a case or should the applicable standard be what a policyholder would have been charged to retain a law firm with experience in this area?.

A handful of states have addressed this question by statute. In California, Civil Code Section 2860 (1996) provides that an insurer is only obligated to pay Cumis counsel the customary hourly rate for defense counsel and may require that the counsel selected by the insured possess certain minimum qualifications, including at least five years of civil litigation experience, including substantial defense experience in the subject at issue in the litigation as well as malpractice coverage.

Absent clear statutory guidelines, “reasonable and necessary” has proven to be an elusive and frustratingly flexible yardstick. Cf. Windt, Insurance Claims and Disputes (3d Ed. 1995), 4.35 at pp. 260-261. In particular, courts have tended to look to the market value that a law firm could command as an hourly rate for a particular type

of case and have not restricted rates to what an insurer could negotiate with its panel counsel.

For instance, the Oregon Supreme Court ruled in Dockins v. State Farm Ins. Co., 985 P.2d 796 (Ore. 2000) that the commercial factors that might persuade the insurer's law firm to accept a lower hourly rate did not apply to the insured's personal counsel, who probably did not have an on-going relationship with that client. The court noted that "lawyers in a position like that of [insurer's] lawyer often have long-term relationships with the insurance companies that they represent fact that tends to drive down their billing rates in comparison to lawyers for insureds, who commonly represent a client in a single matter."

Finally, in the event that a dispute arises concerning the reasonableness of the fees in dispute, the party seeking payment has the burden of presenting evidence of the reasonableness of the fees. In Kaiser v. MEPC American Properties, Inc., 518 N.E.2d 424 (Ill. App. 1978), the Appellate Court of Illinois ruled that a petition for fees must specify the services performed, by whom they were performed, the time expended thereon and the hourly rate. A court may also consider additional factors such as the skill of the attorneys involved, the nature of the case, the novelty and/or difficulties of the issue and work, the importance of the matter, the responsibility required, the usual and customary charge for comparable services, the benefit to the client, and whether there is a reasonable connection between the fees and the amount involved in the litigation.

The standards applicable to fee claims are also detailed in cases where courts have ruled that insureds are entitled to fee awards for suing insurers to compel coverage. For instance, in The Country Club of Johnson, Inc. v. USF&G, No. COA01-726 (N.C. App. May 21, 2002), the North Carolina Court of Appeals ruled that a court should take into account factors such as (1) the difficulty of the case (was the involvement of more than one attorney really necessary?) (2) the legal efforts on the other side that the insured was responding to; (3) that the insured's attorneys had extensive experience and provide high quality legal services that assisted the insured in obtaining a favorable judgment in a difficult case; (4) that counsel's rates were reasonable and consistent with those charged by attorneys with equivalent expertise and experience; (5) that the insured's attorneys divided duties in a reasonable manner so as to avoid duplication of services; and (6) that the services of counsel were reasonable and necessary and that this work was fully documented by affidavits submitted by counsel.

Likewise, in Fireman's Fund Insurance Company of Wisconsin v. Bradley Corporation, 2003 WI 33 (Wis. May 6, 2003), the Wisconsin Supreme Court held that a court should consider the amount and character of the services rendered; the labor, time and trouble involved; the character and importance of the litigation; the amount of money or the value of the property affected; the professional skill and experience called for; the standing of the attorney in his profession; and the general ability of the client to pay and the pecuniary benefit derived from the services.

X: When Must Excess Insurers Defend?

Most of our discussion up to this point has focused on the obligation of general liability insurers. In some cases, however, the primary insurance may have become exhausted. In others, the primary limits may be intact but are plainly inadequate to satisfy the damages claimed by the underlying claimant. In these circumstances, do excess insurers have an equitable or contractual obligation to participate in the defense?

Unlike CGL policies, which contain separate promises to defend and indemnify, excess insurance policies often do not contain an express duty to defend. With the exception of certain umbrella forms, most provide for the payment of defense costs, if at all, only as part of the insured "loss." This undertaking to reimburse defense costs is not the same as the primary insurer's duty to defend. American Casualty Company v. Reading v. Rahn, 854 F.Supp. 492 (W.D. Mich. 1994) and Crown Center Redevelopment Corp. v. Occidental Fire & Cas. Co. of North Carolina, 716 S.W.2d 348 (Mo. App. 1986).

Many excess policies do give the insurer the right to associate in the defense of a case that the insurer believes may impact its excess layer. The question that we will now address is not the exercise of this right, however, but whether the insurer may be obliged to involve itself in the defense against its will.

A. When Is An Excess Insurer's Obligation to Pay Triggered?

Depending on the terms of the insurance contract, an umbrella excess policy's coverage typically does not arise until (1) the underlying insurance becomes exhausted or (2) a claim is presented that is covered by the umbrella policy but is excluded or otherwise outside the primary policy's coverage.

1. Exhaustion of Underlying Insurance

Unless contractually provided for, courts have not required excess insurers to pay defense costs, absent exhaustion of the underlying insurance or some other basis for triggering the excess coverage directly. In Signal Co. v. Harbor Ins. Co., 27 Cal.2d 359, 612 P.2d 889 (1980), the California Supreme Court ruled that an excess insurer has no obligation to share defense costs with primary carriers even if the loss is ultimately settled for more than the primary limits.

An excess insurer's policy obligations normally do not arise until the exhaustion of the primary policy. State Farm v. Jioras, 24 Cal. App.4th 1619 (1994). This has been held to be so even where the primary insurer has committed to paying its limit but has not yet done so. See County of Santa Clara v. USF&G, 868 F.Supp. 274 (N.D. Cal. 1994)(primary policy "deemed" exhausted pursuant to settlement even though payment had not been made yet).

2. Drop Down: "Unavailable" Primary Insurance

Even as to umbrella policies, this duty generally does not arise until the underlying limits of coverage have become exhausted or, depending on the policy, "unavailable" or "uncollectible." These latter terms have prompted a great deal of litigation with respect to whether excess insurers may be forced to "drop down" in the event of an underlying insurer's insolvency. More recently, the "drop down" issue has also arisen in cases where the primary insurer is fully solvent but takes the position that its policy does not provide coverage.

Since most umbrella policies provide that they are to act as "first dollar" insurance for covered losses that are outside the scope of the primary policy, several courts have ruled that the umbrella carrier may have a duty to defend in such cases. See, e.g. Hocker v. New Hampshire Ins. Co., 922 F.2d 1476 (10th Cir. 1991)(Wyoming law); Grossman v. American Family Mutual Ins. Co., 461 N.W.2d 489, 494 (Minn. 1990); School Dist. No. 1 v. Mission Ins. Co., 650 P.2d 929, 944 (Or. App. 1982). This has been held to be true even if the primary insurer has denied coverage on the basis of an exclusion that also appears in the excess carriers' policy. See Hawkins Chemical, Inc. v. Westchester Fire Ins. Co., 159 F.3d 348 (8th Cir. 1998)(Minnesota law).

Not all courts have agreed, however. See Ticor v. Employers Ins. of Wausau, 40 Cal. App.4th 1699, 48 Cal. Rptr.2d 1168 (1995) and In the Matter of the Ancillary Liquidation of Mission Ins. Co., 502 N.W.2d 887 (Wis. App. 1993)(excess insurer has no duty to "drop down" merely because primary insurer has denied coverage).

Even where a duty to defend may be imposed, the excess insurer may obtain reimbursement for the costs that it pays if it can show that the primary insurer wrongly refused to defend. See Church Mut. Ins. Co. v. Smith, 509 S.W.2d 274 (S.D. 1994)(excess insurer could recover on a theory of unjust enrichment, even though it was not in contractual privity with the primary insurer).

B. Must Excess Insurers Pay Defense Costs in "Excess" Cases?

It is not disputed that an excess insurer must contribute to a covered judgment where the amount in question exceeds the underlying retention. Some courts have gone further, however, and have declared that where a judgment or settlement exceeds the primary coverage, the excess insurer should pay a *pro rata* share of defense costs, including costs incurred prior to the date of exhaustion, proportional to its overall share of indemnity. General Accident Ins. Co. of America v. Safety National Casualty Corp., 825 F. Supp. 705, 709-10 (E.D. Pa. 1993); Guaranty National Ins. Co. v. American Motorists Ins. Co., 758 F.Supp. 1394 (D. Mont. 1991); National Grange Mutual Ins. Co. v. Continental Casualty Co., 650 F.Supp. 1404 (S.D.N.Y. 1986); Millers Mutual Ins. Association of Illinois v. Iowa National Mutual Ins. Co., 618 F.Supp. 301 (D. Col. 1985); American Fidelity Ins. Co. v. Employers Mutual Casualty Co., 593 P.2d 14, 22 (Kan. App. 1979); MEEMIC v. Transamerica Ins. Co., 516 N.W.2d 93 (Mich. App. 1994) and American Excess Ins. Co. v. MGM Grand Hotels, Inc., 729 P.2d 1352 (Nev. 1986).

By contrast, a U.S. District Court ruled in Texas Employers Ins. Assoc. v. The Underwriting Members of Lloyds, 836 F.Supp. 398 (S.D. Tex. 1993) that excess insurers are only responsible for defense costs after the exhaustion of primary limits, rejecting the primary insurer's argument that they had a reciprocal and equitable duty to pay a pro rata share of costs where the case plainly had an excess potential.

Likewise, the U.S. Court of Appeals for the Tenth Circuit ruled in a Utah case that an excess insurer had no duty to pay any share of defense costs, even where the settlement exceeded the available primary coverage, where the underlying limits were not paid out until the time of the overall settlement. Utah Power & Light Co. v. Federal Ins. Co., 983 F.2d 1549 (10th Cir. 1993).

The Virginia Supreme Court has ruled that an excess insurer is not obligated to contribute to the cost of defending a suit merely because the *ad damnum* exceeds the underlying limits. U.S. Fire Ins. Co. v. Aspen Building Corp., 367 S.E.2d 478 (Va. 1988).

Finally, a primary policy may be treated in accordance with the foregoing principles where it is made "excess" by reason of a self-insured retention including defense costs. In such circumstances, the California Court of Appeal has ruled there is no defense obligation until the self insured retention is exhausted. General Star Indemnity Co. v. Hard Rock Café, 35 Cal. Rptr. 2d 322 (2d Dist. 1996).

XI: What Terminates The Duty to Defend?

In the ten preceding sections, we have discussed what gives rise to the defense obligation and what is the scope and breadth of the defense duty. In this concluding section, we finally reach the question of when the duty to defend terminates.

The California Supreme Court has described "the defense duty" as "a continuing one, arising on tender of defense and lasting until the underlying lawsuit is concluded or until it has been shown that there is no potential for coverage." Montrose Chemical Corporation v. Canadian Universal Ins. Co., 6 Cal. 4th 287, 295 861 P.2d 1153 (1993).

In fact, the duty to defend may be terminated under either of three circumstances. First, the insurer may exhaust its policy limits. Second, developments in the underlying action may result in the dismissal or elimination of the factual allegations that formed the original basis for the insurer's defense obligation. Finally, the insurer may obtain a court ruling that its policy does not provide insurance coverage for the claims.

A. Exhaustion of Limits

Since 1966, CGL policies have expressly provided that the insurer has no further duty to defend once it has paid out its full indemnity limits. Thus, the insuring agreement in the 1973 CGL form states that the insurer "shall not be obligated to pay

any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.”

With the possible exception of North Carolina, it is generally accepted that a liability insurer's duty to defend terminates upon payment of its policy limit. Pittsburgh Corning Corp. v. Commercial Union, 789 P.2d 214 (3d Cir. 1986); Country Mutual Ins. Co. v. Anderson, 628 N.E.2d 499 (Ill. App. 1993); Maguire v. Ohio Cas. Ins. Co., 602 A.2d 893 (Pa. App. 1992); American States Ins. Co. v. Arnold, 930 S.W.2d 196 (Tx. App. 1996) and Novak v. American Family Mutual Ins. Co., 515 N.W.2d 504 (Wis. App. 1994). But see Brown v. Lumbermens Mut. Cas. Co., 390 S.E.2d 150 (1990)(insurer must continue to defend any pending suits until their conclusion).

There are three limitations to this general rule, however.

1. No Premature Tendering of Limits

First, an insurer may not prematurely terminate its defense obligation by “dumping” its limits. Utah Power & Light Co. v. Federal Ins. Co., 983 F.2d 1549 (10th Cir. 1993)(Utah law); Hartford Accident & Indemnity Co. v. Continental National American Ins. Co., 861 F.2d 118 (9th Cir. 1988); Simmons v. Jeffords, 260 F.Supp. 641 (E.D. Pa. 1966); National Casualty Co. v. INA, 230 F.Supp. 617 (N.D. Ohio 1964); Chubb/Pacific Indemnity Group v. INA, 188 Cal. App. 3d 691, 233 Cal. Rptr. 539 (1987); Anderson v. USF&G, 339 S.E.2d 660 (Ga. 1986); Aetna Cas. & Sur. Co. v. Sullivan, 597 N.E.2d 62 (Mass. App. Ct. 1992) and Nationwide Mutual Ins. Co. v. Simmonds, 434 S.E.2d 277 (S.C. 1993). See also Continental Ins. Co. v. Burr, 706 A.2d 499 (Del. 1998)(payment through interpleader procedure didn't cut off duty to defend).

Note that many recent policy forms have modified this language so that the insurer's duty to defend may not be “exhausted by payment,” which suggests that the insurer may cut off a continuing duty to defend by simply paying its limit under appropriate circumstances. Nevertheless, at least one courts has continued to apply the old analysis to this new language. In Douglas v. Allied American Ins. Co., 2000 Ill. App. LEXIS 164 (5th Dist. March 16, 2000), the Appellate Court of Illinois declared that “exhausted by payments” means that an insurer must defend until its limits are paid pursuant to a judgment or settlement.

For the most part, courts have reasoned that policyholders purchase “litigation insurance” wherein the promised defense is every bit as valuable as the insurer's promise to pay indemnity. However likely it is that the tort claims against the insured will far exceed the available limits, as is often the case in automobile cases where low limits are often matched with grievous damages, the insurer may not accelerate the process by paying the limits into court or tendering them to the plaintiff. Rather, most courts have required that the payment be pursuant to a settlement that results in a release of the plaintiff's claims or, at a minimum, partially extinguishes the policyholder's liability. See, County of Santa Clara v. USF&G, 868 F.Supp. 274, 277 (N.D. Cal. 1994)(“in order to constitute a valid exhaustion of primary coverage, the

[insurer's] payment must be made to satisfy an obligation arising out of either an adjudication or compromise of a third party claim

2. The Problem of Additional Insureds

A specific and complex sub-set of “exhaustion” cases involves the problem of how to address situations where multiple claimants have asserted claims exceeding the available limits and the insurer has an opportunity to pay its limits to settle some, but not all, of the claims against the policyholder.

Some jurisdictions have found that an insurer may not terminate its defense of a suit if there are multiple insured defendant and its payment only results in a partial settlement that would leave the non-settling insureds without either a defense or available indemnity limits.

Although policies provide that additional insureds will be treated severally, their claims are subject to the same “occurrence” limit. Courts have differed, therefore, as to whether an insurer is able to enter into a settlement that extinguishes the available coverage but only extinguishes liability claims against some but not all of the insureds.

The California Court of Appeals has ruled that the payment of the applicable policy limit in settlement of the underlying claims against one insured does not terminate the duty to defend another insured in the same litigation. Shell Oil Co. v. National Union Fire Ins. Co. of Pittsburgh, 44 Cal. App. 4th 1633, 52 Cal. Rptr.2d 580 (2d Dist. 1996)(holding that insured had a duty of good faith and fair dealing to all of its policyholders and was not relieved of its obligations to the others by settling the claims against a single policyholder).

By contrast, the Missouri Court of Appeals has ruled that the duty to defend is terminated by the payment of policy limits, even if the payment only results in a partial settlement and does not extinguish the third party's claims against a particular insured. Millers Mut. Ins. Co. v. Shell Oil Co., 955 S.W.2d 864 (Mo. App. 1997)(settlement as to named insured exhausted any remaining duty to defend additional insured).

In Florida, the District Court of Appeals has taken an intermediate approach, declaring that an insurer can expend its limits to effect a release of some but not all of the claims facing its policyholder so long as the settlements are “reasonable” and are entered into consistent with the insurer’s fiduciary obligations to its policyholder. Farinas v. Florida Farm Bureau General Insurance Company, Case No. 4D02-11 (Fla. DCA 4, April 23, 2003). “Reasonableness” must be determined based on some external source of authority, such as Florida statute Section 624.155(b)(1).

3. Disputes Over Exhaustion

Finally, some courts have ruled that a primary insurer may not withdraw from the defense if the fact of its exhaustion is in dispute.

In Hartford Accident Indemnity Co. v. The Superior Court, 23 Cal. App. 4th 1774, 29 Cal. Rptr.2d 32, 34 (1994), a primary insurer paid its "occurrence" limit in settlement of mass tort claims. The umbrella carrier over it refused to take over the defense of the remaining suits, however, contending that the claims involved multiple "occurrences" and, therefore, that the primary insurer had not exhausted the full extent of its indemnity obligation and had a continuing duty to defend. The California Court of Appeal ruled that, under such circumstances, the primary insurer could not abandon the defense of its insured. On the other hand, the court held that "if an excess carrier shirks its duty to defend after exhaustion of the primary policy wherein the primary carrier continues to provide a defense under a reservation of rights, principles of equity compel the excess carrier to reimburse the primary carrier for the excess carrier's share of the defense costs."

Rulings such as Hartford fail to explain why it is the primary insurer's burden to compel coverage from an excess insurer with whom it is not in privity. Such rulings are in keeping, however, with the monolithic view of the insurance industry that many courts have as well as the general view that policyholders should not be the ones to suffer where coverage is imperiled because of a dispute between two insurers.

B. Developments In The Underlying Litigation

Alternatively, developments in the underlying litigation may render the issue of coverage moot. Just as the general rule is that an insurer must defend its insured until the underlying claims are clearly outside the scope of its coverage, the obverse is that there should be no further defense obligation past the point in time when the remaining claims are clearly not covered. Walsh v. Northbrook Property & Cas. Co., 1999 U.S. Dist. LEXIS 8126 (N.D. Cal. May 26, 1999); Lumbermens Mutual Cas. Co. v. Belleville Industries, Inc., 555 N.E.2d 568 (Mass. 1990); Great American Ins. Co. v. Hartford Ins. Co., 621 N.E.2d 796 (Ohio App. 1993); Village of Morrisville Water and Light Department v. USF&G, 775 F.Supp. 718 (D. Vt. 1991); D'Auria v. Zurich Ins. Co., 507 A.2d 857, 859 (Pa. Super. 1986).

Such developments may come in many forms. A motion for summary judgment may only partially succeed, resulting in the dismissal of some (but not all) of the claims against the insured. Such was the case in Jones v. Clinton where the Arkansas District Court's dismissal of the plaintiff's defamation claim that had formed the basis of President Clinton's insurers agreeing to defend, resulted in a withdrawal of the insurers' participation midway through the Paula Jones case.

Unless the elimination of the covered claims is irrevocable, however, the insurer withdraws from the defense at its own peril. This is particularly true if the rulings are on the eve of trial and subject to challenge on appeal. See Meadowbrook v. Tower Ins. Co., 559 N.W.2d 411 (Minn. 1997)(entry of a partial summary judgment dismissing the covered claims will only terminate the insurer's defense obligations if it is a separate and final appealable judgment and the time for appealing has expired).

On the other hand, a U.S. District Court ruled in Crystal Peak Water Co. v. American Motorist Ins. Co., No. 94-1531 (N.D. Cal. June 22, 1995) that an insurer's duty to defend terminated when the single covered claim was dismissed from the underlying litigation, rejecting the insured's contention that the possibility of a successful appeal or amendment of pleadings created a "potential" for coverage requiring a continued defense under the California Supreme Court's ruling in Montrose I.

Alternatively, new facts may emerge, whether through discovery or the insurer's own investigation, that establish the impossibility of coverage. While such information may terminate any further obligation to pay defense costs, it does not eliminate the duty to defend that existed up to that point. Worcester Ins. Co. v. Dairyland Ins. Co., 555 A.2d 1050, 1053 (Me. 1989).

Nevertheless, in most states, a liability insurer can withdraw its defense once the basis for defending ceases without the necessity of bringing a declaratory judgment action to confirm that right. See . Herbert A. Sullivan, Inc. v. Utica Mutual Ins. Co., SJC 08815 (Mass. May 16, 2003)(insurer did not breach duty to defend by withdrawing after underlying plaintiff filed amended complaint dismissing negligence count that had been soled covered claim in the original suit) and Conway Chevrolet Buick, Inc. v. Travelers Ind. Co., 136 F.3d 210 (1st Cir. 1997)(Massachusetts law).

An insurer that withdraws based on interim developments in the underlying litigation does so at its own peril, however, as further developments could potentially arise that might reactivate its defense obligation. In particular, insureds are likely to argue that an insurer has a continuing duty to defend even after an interlocutory order dismissing the covered causes of action, insofar as there is likely to be an appeal extending to those claims. As discussed in preceding sections, however, the mere risk of future amendments or claims being reasserted should not trigger a defense obligations until such claims are actually asserted.

C. Declaration of No Coverage Obligation

Finally, an insurer's defense obligation may be terminated by the successful outcome of an action for declaratory relief. Indeed, in states such as Illinois and Oklahoma, the failure to bring a claim for declaratory relief can result in an estoppel as to indemnity issues unless the insurer is defending.

As articulated by Ninth Circuit ruled in Envirotech Industries, Inc. v. United Capitol Ins. Assoc., 1998 U.S. App. LEXIS 6175 (9th Cir. March 26, 1998)(unpublished), the general rule in most states is that an insurer need not obtain an adjudication of no coverage before withdrawing from the defense of an action where its investigation has confirmed that no factual basis for coverage exists and the insured has not furnished it with any information to support a claim for coverage. As the Ninth Circuit warned, however, an insurer that makes a unilateral determination that it no longer owes a defense does so as its own peril and may later be found to have acted in bad faith if later developments establish that there was, in fact, coverage.

One means of protecting against any claim of bad faith is the filing of an action for declaratory relief that effects a binding finding of no coverage on the policyholder and third party claims.

Declaratory judgment actions are often viewed as a vehicle whereby policyholders sought to compel coverage from their insurers. However, actions for declaratory relief may also provide a means by which carriers can either obtain avoid claims of bad faith and estoppel as to cases that they are not defending or provide a basis for terminating a defense based on a declaration that there is, in fact, no basis for coverage.

Even so, insurers have sometimes been reluctant to bring actions for declaratory relief, both due to the cost and the perception that they were making war on their policyholders. Nevertheless, in a growing number of states, courts have ruled that insurers cannot "just say no." They must either provide a defense under a reservation of rights or bring a declaratory relief action to resolve the coverage dispute. An insurer that fails to do either, thus leaving the insured entirely to its own resources, will face severe penalties if it is ultimately found to have had a duty to defend, including an estoppel as to whether the loss also falls within the insurer's indemnity. Ames v. Continental Cas. Co., 79 N.C. App. 530, 340 S.E.2d 479 (1986), rev. denied, 316 N.C. 730, 345 S.E.2d 385 (1986) and First Bank of v. Fidelity & Deposit Co. of Maryland, 928 P.2d 298 (Okla. 1996).

On the other hand, in most states the pendency of the declaratory action itself is sufficient to avoid a claim of estoppel; it is not required that it have been the insured who commenced it. Waitzman v. Classic Syndicate, Inc., 648 N.E.2d 246 (Ill. App. 1995) and Professional Office Buildings, Inc. v. Royal Ind. Co., 427 N.W.2d 427, 431 (Wis. App. 1988)("All that is required of the insurer is to seek a court's determination on the coverage issue, instead of refusing to defend based solely upon its own determination of coverage").

The rules governing the filing of actions for declaratory relief differ widely from state to state, particularly with respect to whether (1) the coverage issue must be resolved in a separate proceeding or may be addressed in the context of the underlying tort claim and (2) whether a DJ can be heard immediately or should be stayed pending the disposition of the tort action.

1. *Separate v. Unified Proceedings*

A number of states provide that the coverage issue should be resolved in the tort case rather than through a separate legal proceeding. In Foundation Reserve Ins. Co. v. Mullenix, 642 P.2d 604, 605 (N.M. 1982), the New Mexico Supreme Court declared that "this is the better rule because it prevents multiple suits and avoids the expense to insured of defending a collateral action brought by the insurer for a declaration of the insurer's obligation to defend under the policy." More recently, the Mississippi Supreme Court ruled in Lewis v. Allstate Ins. Co., 730 S.E.2d 65 (Miss. 1998) that although an insurer was free to conduct a declaratory judgment action without waiting for the

disposition of the underlying tort suit, an insured or even the underlying tort plaintiff could ask the judge in the tort action to schedule a hearing to resolve the issue of coverage.

Indeed, the preferred procedure in Wisconsin is for the insurer to intervene in the tort proceeding and seek a stay of the liability claims until such time as the issue of coverage can be resolved. Newhouse v. Citizens Security Mutual Ins. Co., 501 N.W.2d 1 (Wis. 1993). But see Fire Ins. Co. Exchange v. Basten, 536 N.W.2d 150 (Wis. 1996)(recognizing that insurer is also free to bring a petition for declaratory judgment, so long as no Direct Action claims were pending against it and it had not been named as a defendant in the case).

2. Timing Issues

States also differ with respect to whether the coverage suit can proceed in advance of the disposition of the tort action.

Where the disposition of the coverage claim depends on facts that are important to the resolution of the tort case, the DJ may be stayed. Montrose Chemical Corporation v. Canadian Universal Ins. Co., 6 Cal. 4th 287, 861 P.2d 1153 (1993)(coverage litigation must be stayed on any issue that is of material consequence to the underlying claim, such that a ruling in a coverage suit might result in inconsistent results or prejudice to the policyholder); Vanguard Ins. Co. v. Townsend, 544 So.2d 1153 (Fla. App. 1989)(factual issues may not be resolved in a declaratory judgment action if those issues are common to the tort and declaratory judgment actions); American Economy Ins. Co. v. Williams, 805 F.Supp. 859 (D. Idaho 1992); Thornton v. Paul, 384 N.E.2d 335 (Ill. 1978); State Farm Fire & Cas. Co. v. Finney, 770 P.2d 460 (Kan. 1989); Allstate Ins. Co. v. Atwood, 319 Md. 247, 253 (1990) and North Pacific Ins. Co. v. Wilson's Distributing Service, Inc., 908 P.2d 827 (Or. App. 1995).

Delay is not required, however, if, as is more often the case, the facts pertinent to the coverage issues are of marginal consequence in the tort case. American Family Mutual Ins. Co. v. Savickas, 711 N.E.2d 1 (Ill. App. 1998)(whether premium was paid). Nor is delay required where that factual issue has been indisputably resolved in ancillary proceedings, as by a criminal conviction or where the insured may otherwise be collaterally estopped to relitigate the question. Allstate Ins. Co. v. Carioto, 551 N.E.2d 382 (Ill. App. 1990).

Furthermore, as the duty to defend is measured by the pleadings or, in many states, by the facts "known or knowable" at the time of tender, the insurer's defense obligation may in most instances be ruled upon at the very outset. Constitution Assoc. v. New Hampshire Ins. Co., 930 P.2d 556 (Colo. 1996); Cocchi v. National Union Fire Ins. Co. of Pittsburgh, 156 A.D.2d 535, 548 N.Y.S.2d 804 (2d Dept. 1990)(ruling on defense issues not premature; indemnity question must await outcome of liability suit); Farmers Texas County Mutual Ins. Co. v. Griffin, 955 S.W.2d 81 (Tex. 1997). Reisen v. Aetna Life & Casualty Co., 302 S.E.2d 529 (Va. 1983).