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Commentary

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Insurers are finding that breaching their duty to defend comes at the risk of novel, unpredictable, and punitive remedies. Even good faith coverage disputes are being harshly punished by courts through damages that stretch the limits of current jurisprudence and the reasonable needs of both parties. The driving force behind these penalties is the blurring of the previously well-established lines between the duty to defend, the duty to indemnify, and bad faith conduct.

This article will explore the changing legal landscape surrounding the availability of atypical damages that insureds may now be able to seek when an insurer, in good faith, breaches the duty to defend. This article will also discuss the American Law Institute's Restatement of the Law of Liability Insurance project ("Restatement") and its approach to punishing an insurer for its breach of the duty to defend.

Not All Breaches Of The Duty To Defend Are Created Equal

It is a well-honed maxim of contract law that the aggrieved party is entitled to recover for a breach of contract general damages and reasonably foreseeable consequential damages.[1] Applying that maxim to insurance disputes, the relief available to an insured for its insurer's good faith breach of its duty to defend should include only

the reasonably foreseeable and proximately caused damages that compensate the insured for the harm or loss caused by that breach.[2]

That typically meant attorney's fees and litigation costs incurred by the insured in defending itself against the underlying lawsuit.[3] By contrast, if a breach is in bad faith, an insured may be entitled to extra-contractual relief, such as compensatory damages in excess of the original policy limits, court costs and attorney's fees, and/or punitive damages.[4] Until recently, this dichotomy was relatively clear and predictable.

An Ominous Trend Of Harsh Penalties Against Insurers

Insurers should be aware of a recent rash of decisions by state supreme courts and federal circuit courts that expand the panoply of legal remedies available to an insured whose insurer has breached its duty to defend. These cases abandon the time-honored maxim that distinguished between penalties for a good faith breach and those for a bad faith breach of an insurer's duty to defend. Instead, they recognize varied, punitive consequences against insurers that are divorced from the genuineness or diligence of the insurer's decisionmaking. These cases also undermine the most fundamental maxim of coverage law, that the duty to defend is a broader obligation than the duty to indemnify. It is well understood that an insurer may be obligated to defend its insured, although, in the end, it is not obligated to indemnify its insured for any resulting loss. Decisions like those discussed below instead blur these two separate duties.[5] As a consequence, insurers are becoming subject to awards of reputational damages, lost revenue/profits, and aggravation/inconvenience damages; forcing indemnification of uncovered claims and/or excess verdicts; and forfeiture of an insurer's defenses to indemnity. At bottom, this emerging trend of increasingly harsh penalties for insurers that breach their duty to defend, regardless of how the insurer reached its position, seeks to force insurers into the unenviable position of defending uncovered claims. The insurers realize that the penalties for being wrong, even in the face of legitimate doubts about coverage, are just too great to risk.

Central to these atypical remedies available to insureds is an expansive interpretation of what constitutes consequential damages from the breach of the duty to defend. For instance, in *Ryan*, the Second Circuit left open the possibility that an insured could recover reputational damage and lost income as a result of the insurer's incorrect denial of its duty to defend the insured in a securities arbitration. The West Virginia Supreme Court of Appeals similarly allowed the insured to recover "aggravation" and "inconvenience" damages resulting from the insurer's duty to defend, likening those damages to attorney fees recoverable in a subsequent coverage action.[6] A Wisconsin federal district court forced an insurer, which was found to have breached its duty to defend its insured, to pay all of its insured's attorney fees, not just the reasonable ones.[7]

Even more disturbing is a recent line of cases finding insurers liable for an adverse judgment or settlement as a result of their breach of the duty to defend, despite the absence of a finding of bad faith. Most notably, in *Columbia Casualty Co. v. HIAR Holdings*, 411 S.W.3d 258 (Mo. 2013), the Supreme Court of Missouri held an insurer responsible for a settlement millions in excess of the policy limits, reasoning that an insurer "that wrongly refuses to defend is liable for the underlying judgment as damages flowing from its breach of its duty to defend." In doing so, the Supreme Court of Missouri further found that the insurer, by failing to defend, waived all rights to contest the reasonableness of the settlement. The court even dismissed the insurer's arguments that it acted in good faith and that its liability was bound by the limit of the policy.[8]

Notably, *HIAR Holdings* runs contrary to the comments in Section 19 of the current draft of the ALI's Restatement, which states in comment b., "The nondefending insurer is also obligated to pay any covered judgment or the reasonable amount of any covered settlement, subject to the policy limits, but that obligation is part of the insurer's ordinary duty to pay covered claims, not part of the damages for breach of the duty to defend." It also states in comment i., "A breach of the duty to defend does not obligate the insurer to indemnify the insured for amounts in excess of the policy limit. An insurer that breaches the duty to defend may become obligated to pay such amount only as a result of the breach of some other obligation, such as the duty to make reasonable settlement decisions or the duty of good faith or fair dealing."

Perhaps the most concerning anti-insurer penalty created by courts is forfeiture or estoppel. The trend of finding insurers that breach their duty to defend to also

forfeit their defenses to indemnity gained tremendous momentum from a 2013 New York high court decision and early drafts of an authoritative text. However, virtually all of that momentum evaporated with a subsequent decision in the New York case and in subsequent versions of the text. Accordingly, the movement of exacting extreme anti-insurer penalties was rolled back, at least somewhat.

In *K2 Investment Group v. American Guarantee & Liability Insurance Co.*, 22 N.Y.3d 578, 6 N.E.3d 1117 (N.Y. 2014) (informally known as *K2-II*, to distinguish it from a decision it overruled), the New York Court of Appeals initially aligned itself with a minority of courts, such as those in Illinois and Washington. It took the dramatic and unexpected step of finding the subject insurer estopped from asserting its coverage defenses, *i.e.*, the insurer could not rely on policy exclusions to indemnity because it had breached its duty to defend.[9] Fortunately, the New York Court of Appeals realized following rehearing that its approach was contrary to existing case law. Thus, based on the doctrine of *stare decisis*, the Court of Appeals reversed itself to hold that insurers can still contest indemnification after breaching their duty to defend. At bottom, while *K2-II* ultimately yielded a favorable result for insurers, the tribulations leading to *K2-II* caused insurers great anxiety.

In a similar vein, the evolution of the ALI's Restatement, especially with respect to the penalties for a breach of an insurer's duty to defend, has caused insurers anxiety. Section 19 of the September 2015 draft of the Restatement, which is entitled, "Consequences of Breach of the Duty to Defend," now states that an insurer which breaches its duty to defend, and "lacks a reasonable basis for its breach," loses the right to contest coverage, *i.e.*, indemnity for the claim. It then goes on to define a "reasonable basis" as "a coverage defense that is fairly debatable under the law of the relevant jurisdiction, taking all of the facts favoring coverage to be true." Admittedly, the Restatement's current iteration upholds the distinction between the duty to defend and the duty to indemnify and between good faith and bad faith breaches of the duty to defend. It also correctly characterizes the "forfeiture" or "estoppel" rule as the minority rule.

However, for years in the previous iterations (including when it was a Principles project), the ALI purported to espouse a "better rule" that "a liability insurer that breaches the duty to defend loses the right to contest coverage for the claim." Like *K2-I*, this development would have created untold problems for insurers, certainly resulting in courts forcing numerous insurers to cover risks that were not otherwise purchased by policyholders.

Like the New York Court of Appeals, the ALI correctly recognized (after much handwringing) that to adopt a minority position on estoppel would unfairly enlarge the bargained for coverage by making insurers guarantors for non-covered losses and otherwise obliterate the crucial distinction between the duty to defend and the duty to indemnify. This recent departure from the minority position the Restatement previously espoused is undoubtedly welcomed by the insurance industry. That is particularly because the Restatement has great potential to be an authoritative resource courts can look to in deciding issues, especially novel ones or ones that are the product of a lower court split.[10]

Achieving The Delicate Balance

The recent, wild changes in the law with respect to the breach of an insurer's duty to defend have sparked great controversy. Historically, insurers could invoke coverage defenses in good faith, but with some solace that the penalties for being incorrect would be less than those associated with invoking coverage defenses in bad faith. While there have always been a variety of consequences for an insurer's breach of its duty to defend, they generally have been contingent on the insurer's good faith or bad faith conduct.

Today, however, insurers must be cognizant that a mere breach of its duty to defend could result in a quagmire of different and uncertain outcomes. That is because some courts throughout the country are imposing increasingly severe and unorthodox consequences on insurers. In particular, some are doing away with the dichotomy between good faith and bad faith breaches; others are accepting a broadened scope of consequential damages, finding a causal connection between a contractual breach and many types of relief that were previously deemed unrelated to the breach; and some are even blurring the line between the duty to defend and the duty to indemnify, to the point of disregarding the policy limits and also effectively providing coverage to insureds that they did not purchase. Taken together, these developments place enormous pressure on insurers

when confronted with a claim that contains fairly debatable or legitimate coverage questions. Insurers know that in a hostile jurisdiction, they may be found liable for draconian penalties, including paying for uncovered losses, even if they arguably acted in good faith.

Ultimately, this alarming trend has the potential to create an unpredictable decision calculus for insurers that may no longer be able to reasonably anticipate consequences from an incorrect coverage determination. At the same time, insurers should be cognizant of the problematic scenarios created by the blurring of the lines between the duty to defend, the duty to indemnify, and bad faith. The import for insurers is that disclaiming coverage is now not only a delicate situation, but one that could be extremely costly, regardless of the legitimacy or propriety of an insurer's decisionmaking.

Endnotes

1. *See, e.g.*, *Basic Capital Mgmt., Inc. v. Dynex Commercial, Inc.*, 348 S.W.3d 894, 901 (Tex. 2011); *Linc Equip. Servs. v. Signal Med. Servs.*, 319 F.3d 288, 289 (7th Cir. 2003), applying *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854); *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 801 (Utah 1985); *Liss & Marion, P.C. v. Recordex Acquisition Corp.*, 603 Pa. 198, 983 A.2d 652, 662 (2009).

2. *See, e.g.*, *Platinum Tech., Inc. v. Fed. Ins. Co.*, 282 F.3d 927, 932-933 (7th Cir. 2002); *South Dakota State Cement Plant Comm'n v. Wausau Underwriters Ins. Co.*, 2000 SD 116, ¶ 43 (S.D. 2000); *State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co.*, 88 Cal. Rptr. 246, 259 (Cal. App. 3d Dist. 1970).

3. *See, e.g.*, *Andrew v. Century Surety Co.*, No. 2:12-cv-00978-APG-PAL, 2014 U.S. Dist. LEXIS 60972 (D. Nev. June 20, 2014) (breaching the duty to defend can only result in commonplace contractual damages; the breach does not entitle the insured to recover the amount of an excess judgment).

4. *Ryan v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 692 F.3d 162 (2d Cir. 2012); *Green v. J.C. Penney Auto Ins. Co.*, 806 F.2d 759 (7th Cir. 1986); *Am. Cas. Co. of Reading, Pa. v. Health Care Indem., Inc.*, 613 F. Supp. 2d 1310 (M.D. Fla 2009); *Kirk v. Mount Airy Ins. Co.*, 134 Wn.2d 558, 570 (Wash. 1998).

5. *Khan v. Landmark Am. Ins. Co.*, 326 Ga. App. 539, 757 S.E.2d 151, 154 (2014) (by refusing to defend the insured, the insurer did not waive its right to contest coverage because the "question of whether the policy provides coverage for the claim is separate from the legal consequences of an insurer's refusal to indemnify or defend").

6. *Graham v. Nat'l Union Fire Co. of Pittsburgh, PA*, 556 Fed. App'x 193 (4th Cir. 2014).

7. *Fleet & Farm of Green Bay, Inc. v. United Fire & Cas. Co.*, No. 13-cv-1013, 2015 U.S. Dist. LEXIS 136991 (E.D. Wis. Oct. 7, 2015).

8. *See also Auto Flat Car Crushers, Inc. v. Hanover Ins. Co.*, 469 Mass. 813, 17 N.E.3d 1066 (2014) (an insurer that breaches its duty to defend may be liable for all natural consequences of the breach that place the insured in a worse position, potentially including the amount of the settlement in the underlying litigation); *Tidyman's Mgmt. Servs. Inc. v. Davis*, 2014 MT 205, 330 P.3d 1139 (affirming the rule that "an insurer who breaches the duty to defend is liable for the full amount of the judgment, including amounts in excess of policy limits").

9. Dan D. Kohane and Elizabeth A. Fitzpatrick, "Breaching the Duty to Defend—Let Reason and Logic Govern the Penalty," DRI: Covered Events, 2015 Issue 9; Michael F. Aylward & Lorelie S. Masters, "A 'Principled' Approach to Coverage? The American Law Institute and Its 'Principles of the Law of Liability Insurance,'" DRI Insurance Coverage and Practice Symposium, December 2013.

10. Michael F. Aylward, "The Restatement of the Law of Liability Insurance: 2015 Progress Report, DRI: Covered Events, 2015 Issue 9 (the stated goal of the Restatement is to codify insurance law). ■

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