

**RESERVING THE RIGHT TO CONTEST COVERAGE UNDER THE  
PROPOSED RESTATEMENT OF THE LAW OF LIABILITY  
INSURANCE**

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I. INTRODUCTION

The American Law Institute (“ALI”) is currently engaged in creating the first Restatement of the Law of Liability Insurance (the “Restatement”).<sup>1</sup> The Restatement addresses the duty to defend in sections 10–23, and the duty to make reasonable settlement decisions (which is a critical part of the duty to defend) in sections 24–28.

The duty to defend may be the most important obligation of a liability insurance company. It raises fundamental issues of good faith, as the duty to defend is based upon a relationship of trust and confidence akin to a fiduciary relationship.<sup>2</sup> Liability insurance has been called “litigation insurance”<sup>3</sup> because it is designed not only to pay for judgments and

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1. At the time of the drafting of this Article, sections 12–15 of Chapter 2 were approved by the membership of the ALI at the 2013 Annual Meeting subject to the discussion at that Meeting and to editorial prerogative. Sections 16–34 of Chapter 2 were approved by the membership at the 2014 Annual Meeting subject to the discussion at that Meeting and to editorial prerogative.

2. *Birth Ctr. v. St. Paul Cos.*, 787 A.2d 376, 388 n.17 (Pa. 2001) (noting that “[b]ecause of the insurer’s controlling role in the litigation, the insurer enters a fiduciary relationship with its insured and accepts the responsibility to protect the interests of its insured” (citing *Gray v. Nationwide Mut. Ins. Co.*, 223 A.2d 8 (Pa. 1966))).

3. Seth D. Lamden, *Duty to Defend*, in 3 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 17.01 (Jeffrey E. Thomas & Francis J. Mootz III eds., 2014).

settlements, but also to defend against claims, whether meritless or not, alleging liability that has any *potential* to fall within the coverage of the insurance policy.

Section 10 of the Restatement sets forth, perhaps for the first time, the scope of an insurance company's "right" to defend,<sup>4</sup> which typically appears in liability insurance policies alongside the "duty" to defend. The right to defend gives the insurance company the authority to direct the activities of the defense and to receive information relevant to the defense, albeit with some restrictions. Under section 11, for example, the Restatement recognizes that a liability insurance company has no right to receive confidential information of the policyholder if that information could be used to advantage the insurance company at the expense of the policyholder.<sup>5</sup> Indeed, section 14(1)(b) of the Restatement requires that the defense avoid disclosure to the insurance company of any confidential information that could be used to advantage the insurance company at the policyholder's expense.<sup>6</sup> Furthermore, section 12 of the Restatement establishes the insurance company's vicarious liability for the breach of a professional obligation by defense counsel.<sup>7</sup> Thus, the insurance company has a duty to supervise the defense of the claim and can be held liable vicariously for the defense counsel's professional negligence.

Section 13 of the Restatement describes the conditions under which the insurance company must assume its duty to defend,<sup>8</sup> reflecting the well-established principle that the duty to defend is broader than the duty to indemnify.<sup>9</sup> The duty to defend arises where the claim is based, *in whole or in part*, on any set of alleged facts and an associated legal theory that, if proven, would be covered by the policy.<sup>10</sup> Section 14 describes the

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4. RESTATEMENT OF THE LAW OF LIAB. INS. § 10 (AM. LAW INST., Discussion Draft 2015).

5. *Id.* § 11(2). Reporters' note d to section 11 recognizes the practical difficulties reflected in the precedent, which struggles to reconcile a policyholder's duty to cooperate in the defense with the policyholder's right to protect the attorney-client privilege. *Id.* § 11 reporters' note d. The Restatement properly protects privilege, provides the insurance company with access to information necessary to defend the policyholder, and denies the insurance company access to information that could be used to disadvantage the policyholder. *Id.*; see also *id.* § 14 cmt. e.

6. *Id.* § 14(1)(b).

7. *Id.* § 12.

8. *Id.* § 13.

9. *E.g.*, *Quihuis v. State Farm Mut. Auto. Ins. Co.*, 334 P.3d 719, 727 (Ariz. 2014) (citing *United Servs. Auto. Ass'n v. Morris*, 741 P.2d 246, 252 (Ariz. 1987)); *Tidyman's Mgmt. Servs. Inc. v. Davis*, 330 P.3d 1139, 1149 (Mont. 2014) (quoting *Farmers Union Mut. Ins. Co. v. Staples*, 90 P.3d 381, 385 (Mont. 2004)); *Nat'l Sur. Corp. v. Immunex Corp.*, 297 P.3d 688, 691 (Wash. 2013) (en banc) (citing *Truck Ins. Exch. v. Vanport Homes, Inc.*, 58 P.3d 276, 281 (Wash. 2002) (en banc)).

10. RESTATEMENT OF THE LAW OF LIAB. INS. § 13(a) (AM. LAW INST., Discussion Draft 2015); *Travelers Cas. & Sur. Co. of Am. v. Neth. Ins. Co.*, 95 A.3d 1031, 1049 (Conn. 2014);

basic obligations of an insurance company when the liability insurance policy obligates the insurance company to defend a claim, including the duty to make reasonable efforts to protect against both covered and uncovered liability.<sup>11</sup> Uncovered liability can include amounts within a deductible, amounts above the limits, or liability for uncovered claims or damages.

Section 15 addresses an insurance company's reservation of rights to contest coverage, including requirements regarding the timing and content of reservation of rights letters.<sup>12</sup> When the allegations of the claim are covered in whole, the insurance company should assume the defense of the policyholder without reservation. When the allegations are covered in part, or are otherwise only *potentially* covered (such as when the allegations are insufficient to determine whether or not they may be covered), the insurance company should defend the policyholder under a reservation of the right to deny coverage later for any liability that falls outside of coverage. When the allegations of the claim present no potential for coverage, the insurance company should promptly deny coverage, disclaiming both its right and duty to defend. The insurance company must make this critical analysis promptly upon receipt of notice. The value of section 15 is that it presents, clearly and without equivocation, how and when an insurance company may reserve its rights to later contest coverage. Notably, section 25 makes clear that a reservation of the right to contest coverage does not relieve an insurance company from the duty to make reasonable settlement decisions.<sup>13</sup>

Sections 16 and 17 address when and how an insurance company must provide a defense independent of the control of the insurance company.<sup>14</sup> In section 18, the Restatement explains how the duty to defend terminates.<sup>15</sup> Then, the Restatement sets forth the consequences of an "ordinary breach" of the duty to defend in section 19.<sup>16</sup> Sections 20–23 address particular issues that arise in the defense of liability claims, including: when multiple insurance companies have a duty to defend a claim,<sup>17</sup> whether an insurance company may seek reimbursement of defense costs,<sup>18</sup> and how to treat insurance policies that provide a right to

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Amica Mut. Ins. Co. v. Mutrie, 105 A.3d 595, 597–98 (N.H. 2014) (quoting Progressive N. Ins. Co. v. Argonaut Ins. Co., 20 A.3d 977, 980 (N.H. 2011)).

11. RESTATEMENT OF THE LAW OF LIAB. INS. § 14 (AM. LAW INST., Discussion Draft 2015).

12. *Id.* § 15.

13. *Id.* § 25(1).

14. *Id.* §§ 16, 17.

15. *Id.* § 18.

16. *Id.* § 19.

17. *Id.* § 20.

18. *Id.* § 21.

indemnification of defense costs<sup>19</sup> or a right to associate in the defense,<sup>20</sup> as distinguished from a right and duty to defend.

This Article will focus on section 15 of the Restatement, how it interacts with other sections, and how it reflects and advances the trends of the common law. Read holistically, the Restatement presents a concise guide for carriers and courts about how insurance companies can properly reserve their rights to contest coverage and the consequences of failing to do so.

## II. SECTION 15. RESERVING THE RIGHT TO CONTEST COVERAGE

A thoughtful, inclusive reservation of rights letter protects both the interests of the policyholder and the insurance company. As the Supreme Court of Illinois reasoned, “[w]hen an insurer defends a claim against its insured under a sufficient reservation of rights,” it benefits both the policyholder and the insurance company because “the insured then can intelligently choose between retaining her own counsel, or accepting defense counsel provided by the insurer, and cannot so easily claim that it was prejudiced by the insurer’s conflict of interest.”<sup>21</sup> Of course, the option of being able to retain one’s own counsel may be illusory due to the policyholder’s financial condition. A liability insurance policy is designed to avoid legal expenses, so to the extent that a policyholder feels compelled to retain separate counsel *at his or her own expense*, the purpose of the insurance has been undermined. Thus, the real importance of a defense under a reservation of rights is that it encourages an insurance company to defend, instead of disclaim.

The Restatement describes a proper reservation of rights as allowing the policyholder “the opportunity to engage with the defense at a level

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19. *Id.* § 22.

20. *Id.* § 23.

21. *Standard Mut. Ins. Co. v. Lay*, 989 N.E.2d 591, 596 (Ill. 2013). Similarly, the Supreme Court of Washington optimistically described the balance: when an insurance company assumes the defense under a reservation of rights, “the insured receives the defense promised and, if coverage is found not to exist, the insurer will not be obligated to pay.” *Am. Best Food, Inc. v. Alea London, Ltd.*, 229 P.3d 693, 696 (Wash. 2010) (quoting *Truck Ins. Exch. v. Van Port Homes, Inc.*, 58 P.3d 276, 282 (Wash. 2002) (en banc)); *see also* Ward Douglas Smith, Comment, *Reservation of Rights Notices and Nonwaiver Agreements*, 12 PAC. L.J. 763, 768 (1981) (“The purpose of the typical insurance defense clause is twofold. First, the insurer desires to minimize its losses by reserving the right to retain competent counsel who will conduct the defense efficiently and thereby increase the likelihood that the insured will prevail in the suit brought by the injured party or, in the alternative, effectuate a reasonable settlement. Second, the insured relies upon the insurer to protect his or her legal, economic, and societal interests vigorously so that day to day responsibilities are not interrupted.” (footnote omitted)).

appropriate to the risk.”<sup>22</sup> This is made clear when viewed in conjunction with the other options. If an insurance company disclaims the duty to defend, the policyholder knows it must fend for itself. If the insurance company assumes the defense without reservation, then the policyholder can expect, and demand, full coverage of any settlements or judgments. A reservation of rights provides clarity to the gray areas of coverage. It lets the policyholder know how the insurance company sees its potential duty to pay any settlements or judgments, and the policyholder can take whatever actions may be necessary to protect itself from uninsured exposures.

Section 15 of the Restatement delineates the contours of an insurance company’s obligation to reserve its right to contest coverage:

- (1) An insurer that undertakes the defense of a claim may later contest coverage for the claim only if it provides timely notice to the insured, before undertaking the defense, of any ground for contesting coverage of which it knows or should know.
- (2) If an insurer already defending a claim learns of information that provides a ground for contesting coverage, the insurer must give notice of that ground to the insured within a reasonable time in order to reserve the right to contest coverage of the claim on that ground.
- (3) Notice to the insured of a ground for contesting coverage must include a written explanation of the ground, including the specific insurance policy terms and facts upon which the potential coverage defense is based, in language that is understandable by a reasonable person in the position of the insured.
- (4) When an insurer reasonably cannot complete its investigation of a claim before undertaking the defense, the insurer may temporarily reserve its right to contest coverage for the claim by providing to the insured, in language that is understandable by a reasonable person in the position of the insured, an initial, general notice of reservation of rights, but to preserve that reservation

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22. RESTATEMENT OF THE LAW OF LIAB. INS. § 15 cmt. a (AM. LAW INST., Discussion Draft 2015).

of rights the insurer must pursue that investigation with reasonable diligence and must provide the detailed notice stated in subsection (3) within a reasonable time.<sup>23</sup>

A. *Waiver of Right to Contest Coverage*

Section 15 begins with the premise that the “right to contest coverage” must be asserted by a liability insurance company that assumes the defense of the policyholder in a liability claim; if not timely and properly asserted, the “right to contest coverage” is waived.<sup>24</sup>

If an insurance company “undertakes the defense of a claim,” the insurance company may later contest coverage for the claim “only if it provides timely notice to the insured, before undertaking the defense, of any ground for contesting coverage of which it knows or should know.”<sup>25</sup> There are elements of both timing and content in the requirements of section 15. First, with some exceptions, the notice to the policyholder must be sent before the insurance company undertakes the defense (the “Timing Requirement”). Second, that notice must provide notice “of any ground for contesting coverage of which [the insurance company] knows or should know” (the “Content Requirement”).<sup>26</sup>

1. The Timing Requirement

Although the reservation of rights generally must be sent before the insurance company undertakes the defense as set forth in section 15(1), the Timing Requirement is discussed further in section 15(2). If the insurance company does not know of a ground for contesting coverage, and there is no reason the insurance company should have known of that ground, it may still reserve its rights.<sup>27</sup> Accordingly, if the insurance company later receives information that provides a new ground for contesting coverage, the insurance company may reserve the right to contest coverage on that ground, *but only if* the insurance company gives notice to the policyholder “within a reasonable time.”<sup>28</sup> Ultimately, it is the policyholder’s burden of proof to show that the insurance company

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23. *Id.* § 15(1)–(4).

24. *Id.* § 15(1).

25. *Id.*

26. *Id.*

27. *See id.* § 15(2).

28. *Id.*

should have known of the ground for contesting coverage at an earlier date.<sup>29</sup>

## 2. The Content Requirement

Section 15(3) of the Restatement explains the required content of the notice that must be provided in a reservation of rights letter.<sup>30</sup> The Content Requirement has four components:

*First*, the notice must be written.<sup>31</sup> Oral reservations of rights are ineffective.

*Second*, the notice must cite the specific insurance policy terms that provide the ground for the reservation.<sup>32</sup> General references to concepts or issues, without anchor in the policy language, will not be sufficient.

*Third*, the reservation must include the facts upon which the potential coverage defense is based.<sup>33</sup> The Restatement is not entirely clear about whether an initial recitation of the facts within the letter is sufficient or whether the insurance company needs to explain the connection between the facts and the policy language, but the latter is certainly preferable and may be necessary for the reservation to be understandable.

*Fourth*, the language of the reservation must be “understandable by a reasonable person in the position of the insured.”<sup>34</sup> As noted, this requirement would seem to mandate an explanation, in plain language, of the connection between the policy language cited and the facts alleged. The notice must fairly inform the policyholder of the reservation.

## 3. The Duty to Speak

If the insurance company assumes the defense without providing any notice to the policyholder of any grounds for contesting coverage, the insurance company *generally* may not later contest coverage for the claim on any basis. Likewise, if the insurance company provides notice of three grounds for contesting coverage, the insurance company *generally* will not be heard to assert a new, fourth ground for contesting coverage at a later date. Such new grounds may be raised *only* if they were unknown, and could not have been known by a reasonable investigation prior to the

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29. *Id.* § 15 cmt. c (placing the burden on the policyholder due to “the harsh consequences for an insurer that has not adequately reserved its rights”).

30. *Id.* § 15(3).

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

assumption of the defense, and *only* if the policyholder is advised of those grounds within a reasonable time.<sup>35</sup>

Thus, regardless of whether an earlier reservation of rights has been provided on other grounds, a new ground for contesting coverage may not be raised if the insurance company knew or should have known of that ground for contesting coverage prior to assuming the defense. Furthermore, if a new ground is to be raised, then the insurance company must provide notice within a reasonable time, and that notice must meet the Content Requirement set forth in section 15(3).

Section 15 is not a rule of estoppel requiring the policyholder to show detrimental reliance on the statements or omissions of the insurance company.<sup>36</sup> Rather, it places upon the insurance company a duty to speak. If the insurance company remains silent while assuming the defense, it will later be precluded from contesting coverage. The assumption of the defense gives the insurance company substantial rights, privileges, and obligations; thus, it is critical that the reservation of the right to contest coverage be communicated clearly prior to the assumption of the defense. If it is not, waiver is the appropriate remedy.

The only exception to waiver should be, and is under the Restatement, when the insurance company does not have access to the facts necessary for the reservation until sometime later.<sup>37</sup> Lawsuits can evolve and change, as can the policyholder's requests for coverage.<sup>38</sup> Of course, the insurance company cannot delay in obtaining facts, but must conduct a timely investigation. Typically, an insurance company will possess the complaint, arbitration demand, or other document setting forth the claim, as well as the provisions of its insurance policy, before it assumes the defense, and accordingly will be deemed to be on notice of those facts.<sup>39</sup> If the grounds for contesting coverage are evident upon a reading of those documents, such grounds must be raised prior to the assumption of the defense and cannot be preserved by a general reservation lacking specificity.

Section 15(4) limits "general" reservations of rights. Although an insurance company may provide a general reservation of rights when it reasonably cannot complete its claim investigation before undertaking

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35. *Id.* § 15(2)–(4).

36. *Id.* § 15 cmt. a.

37. *Id.* § 15(4).

38. *Nat'l Fire Ins. Co. v. Entm't Specialty Ins. Servs., Inc.*, 485 F. Supp. 2d 737, 741–42 (N.D. Tex. 2007) (ruling that the insurer did not waive its right to assert an exclusion not identified in its reservation of rights where the exclusion was triggered only after the petition had been amended); *see also* *Capitol Envtl. Servs., Inc. v. N. River Ins. Co.*, 536 F. Supp. 2d 633, 641 (E.D. Va. 2008).

39. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 15 cmt. c (AM. LAW INST., Discussion Draft 2015).

the defense, the insurance company must pursue that investigation with all reasonable diligence and must provide the detailed reservation of rights letter within a reasonable time.<sup>40</sup> The Restatement takes a reasonable middle ground with regard to general reservations—allowing them, but only when necessitated by the circumstances and only if a more specific notice follows within a reasonable time.

### *B. Interaction with the Common Law*

The recognition in section 15 of insurance company obligations with respect to the timing and content of reservation of rights letters accords with basic principles of insurance law recognized by commentators and courts across jurisdictions. Those principles include the doctrines of waiver, estoppel, and *mens rea*, as well as the duty of good faith and fair dealing.

#### 1. Waiver

Waiver is the voluntary relinquishment of a known right, including conduct evidencing the abandonment of a known right.<sup>41</sup> The Restatement recognizes that the assumption of the defense of a claim without a proper reservation of rights is conduct evidencing the abandonment of a known right.<sup>42</sup> There is no requirement that the policyholder prove prejudice to its interests or detrimental reliance. This accords with “the general or majority rule” in estoppel cases that conclusively presumes prejudice or recognizes that the policyholder’s loss of the right to control and manage the defense is itself prejudice.<sup>43</sup>

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40. *Id.* § 15(4).

41. *Lumbermen’s Mut. Cas. Co. v. Sykes*, 890 N.E.2d 1086, 1097 (Ill. App. Ct. 2008) (“[W]aiver is ‘an equitable principle invoked to further the interests of justice whenever a party initially relinquishes a known right or acts in such manner as to warrant an inference of such relinquishment.’” (quoting *Mollihan v. Stephany*, 368 N.E.2d 465, 470 (Ill. App. Ct. 1977))); *Long Island Lighting Co. v. Am. Re-Ins. Co.*, 998 N.Y.S.2d 169, 171 (App. Div. 2014) (noting that an insurance company’s failure to assert a known policy defense may constitute a waiver).

42. See RESTATEMENT OF THE LAW OF LIAB. INS. § 15(1) (AM. LAW INST., Discussion Draft 2015) (“An [insurance company] that undertakes the defense of a claim may later contest coverage for the claim *only if* it provides timely notice to the insured, before undertaking the defense, of any ground for contesting coverage of which it knows or should know.” (emphasis added)).

43. *World Harvest Church, Inc. v. GuideOne Mut. Ins. Co.*, 695 S.E.2d 6, 11 (Ga. 2010).

## 2. Estoppel

Comment a to section 15 acknowledges that the rule requiring liability insurance companies to provide a reservation of rights was “originally grounded in estoppel.”<sup>44</sup> Estoppel is an equitable doctrine that prevents a party from taking advantage of its own misleading words or actions on which another has relied.<sup>45</sup> The Restatement does not adopt a rule of estoppel, but instead recognizes waiver.<sup>46</sup>

In cases based on estoppel, courts look to whether the policyholder suffered detriment from the timing of the reservation of rights. For example, in *Lumbermen’s Mutual Casualty Co. v. Sykes*, Lumbermen’s sought a declaration that it did not owe coverage for mold damage to Ms. Sykes’ home.<sup>47</sup> Ms. Sykes argued, inter alia, that because she moved out of her home and retained a vendor to perform remediation on her home in reliance on Lumbermen’s’ assurances that she would be covered, Lumbermen’s should be estopped from subsequently denying coverage.<sup>48</sup> In partially affirming summary judgment, the court held that Ms. Sykes had established the elements of estoppel as a matter of law.<sup>49</sup> The court rejected Lumbermen’s’ argument that a November 2001 reservation of rights letter defeated any reasonable reliance argument because subsequent letters admitting coverage justified Ms. Sykes’ reliance.<sup>50</sup> The court did note, however, that the doctrine of estoppel could not apply where “the defendant’s conduct terminated within ample time to allow the plaintiff to still avail [her]self of any legal rights [s]he may have had.”<sup>51</sup> Lumbermen’s sent a March 2002 letter stating that, while a large part of the mold damage would be covered, certain mold damage would not be.<sup>52</sup> The court held that Lumbermen’s was estopped from denying coverage for damages and costs incurred prior to the March 2002 letter,

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44. RESTATEMENT OF THE LAW OF LIAB. INS. § 15 cmt. a (AM. LAW INST., Discussion Draft 2015).

45. See *Lumbermen’s*, 890 N.E.2d at 1101.

46. RESTATEMENT OF THE LAW OF LIAB. INS. § 15 cmt. a (AM. LAW INST., Discussion Draft 2015).

47. 890 N.E.2d at 1089.

48. *Id.* at 1101.

49. *Id.* at 1102. The court noted that in the insurance context, estoppel “requires the [policyholder] to establish the following: “(1) that he was misled by the acts or statements of the [insurance company] or its agent; (2) reliance by the [policyholder] on those representations; (3) that such reliance was reasonable; and (4) detriment or prejudice suffered by the [policyholder] based on the reliance.”” *Id.* at 1101 (quoting *Chatham Corp. v. Dann Ins.*, 812 N.E.2d 483, 494 (Ill. App. Ct. 2004)).

50. *Id.* at 1103.

51. *Id.* at 1105 (quoting *Smith v. Cook Cty. Hosp.*, 518 N.E.2d 336, 342 (Ill. App. Ct. 1987)).

52. *Id.* at 1091.

but remanded for the trial court to determine to what extent Ms. Sykes' reliance on the coverage admissions in the March 2002 letter was reasonable, as related to damages she incurred after the letter.<sup>53</sup>

Many other cases decided under an estoppel rationale would be better framed as waiver. For example, the Supreme Court of Georgia, answering certified questions from the United States Court of Appeals for the Eleventh Circuit, ruled that an insurance company was estopped from asserting a defense of non-coverage when it assumed and conducted a defense without notifying the policyholder that it was doing so under a reservation of rights.<sup>54</sup> The court held that an insurance company is "deemed estopped" from asserting the defense of non-coverage regardless of whether the policyholder can show prejudice.<sup>55</sup> The Supreme Court of Georgia noted that "the insured has surrendered innumerable rights associated with the control of the defense including choice of counsel, the ability to negotiate a settlement, along with determining the timing of such negotiations, and the ability to decide when and if certain defenses or claims will be asserted."<sup>56</sup> Thus, the court framed the issue as estoppel, but then required no particularized proof of detrimental reliance or prejudice. As a result, the rule of decision acts much more like waiver than traditional estoppel.<sup>57</sup>

The Restatement recognizes this "practical reality" and adopts a simple rule: "Insurers that do not timely reserve their rights to contest coverage lose those rights."<sup>58</sup> The Restatement justifies rejection of the estoppel rule on two grounds: (1) "[T]he rule is now so well established that an insurer that does not raise a ground for contesting coverage should be understood to have waived its right to contest coverage in nearly all cases"; and (2) "there are situations in which it would be very difficult for the insured to demonstrate detrimental reliance, particularly in the consumer context."<sup>59</sup> For these reasons, the Restatement properly grounds the remedy for a failure to properly reserve rights in the doctrine of waiver.

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53. *Id.* at 1105–06.

54. *World Harvest Church, Inc. v. GuideOne Mut. Ins. Co.*, 695 S.E.2d 6, 12 (Ga. 2010).

55. *Id.*

56. *Id.* (quoting *Nw. Nat'l Ins. Co. v. R.S. Armstrong & Bros. Co.*, 627 F. Supp. 951, 956 (D.S.C. 1985)).

57. *See Knox-Tenn Rental Co. v. Home Ins. Co.*, 2 F.3d 678, 684 (6th Cir. 1993) ("The rule [regarding an insurer's failure to inform an insured that it was defending pursuant to a reservation of rights] by its very language establishes the presumption of prejudice. Otherwise, there would be no necessity for its promulgation." (alteration in original) (quoting *Am. Home Assurance Co. v. Ozburn-Hessey Storage Co.*, 817 S.W.2d 672, 675 (Tenn. 1991))).

58. RESTATEMENT OF THE LAW OF LIAB. INS. § 15 cmt. a (AM. LAW INST., Discussion Draft 2015).

59. *Id.*

*C. Mend the Hold*

The mend the hold doctrine prohibits parties to a contract from altering or raising new positions in litigation to avoid performance. The United States Supreme Court has explained that “[w]here a party gives a reason for his conduct and decision touching any thing involved in a controversy, he cannot, after litigation has begun, change his ground, and put his conduct upon another and a different consideration. He is not permitted thus to mend his hold.”<sup>60</sup> The mend the hold doctrine is frequently applied in insurance disputes.<sup>61</sup> The Restatement’s requirement of prompt and understandable reservations of rights accords with the mend the hold doctrine.

The Pennsylvania Supreme Court invoked the mend the hold doctrine to prevent an insurance company from adding a reason to its denial that had not been initially expressed. In that case, the insurance company cancelled a policy due to non-payment and then subsequently argued that cancellation was justified, instead, due to the insolvency of its fellow contracting party.<sup>62</sup> The court reasoned that “[t]he trend of our decisions has been to hold insurance companies to good faith and frankness in not concealing the ground of defense, and thus misleading the insured to his disadvantage. . . . [H]aving specified a ground of defense, very slight evidence has been held sufficient to establish a waiver as to other grounds.”<sup>63</sup> Included in the court’s reasoning was the insurance company’s “duty to speak.”<sup>64</sup>

In *Karpenski v. American General Life Cos.*, the United States District Court for the Western District of Washington invoked the mend the hold doctrine to preclude a disability insurance company from denying coverage on grounds that the policyholder had made misrepresentations about health disorders in her application for insurance, where the insurance company had relied on certain *other* alleged misrepresentations in its denial letter.<sup>65</sup> Notably, the court rejected the insurance company’s argument that a general reservation of rights to disclaim coverage on additional, unspecified grounds was sufficient to preserve its right to subsequently articulate additional bases for rescission.<sup>66</sup> However, the mend the hold doctrine applied in

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60. *Ohio & Miss. Ry. Co. v. McCarthy*, 96 U.S. 258, 267–68 (1877).

61. *See, e.g.*, *Harbor Ins. Co. v. Cont’l Bank Corp.*, 922 F.2d 357, 362–65 (7th Cir. 1990); *Integrated Measurement Sys. v. Int’l Commercial Bank of China*, 757 F. Supp. 938, 947 n.14 (N.D. Ill. 1991).

62. *Honesdale Ice Co. v. Lake Lodore Improvement Co.*, 81 A. 306, 307 (Pa. 1911).

63. *Id.* (quoting *Freedman v. Fire Ass’n of Phila.*, 32 A. 39, 40–41 (1895)).

64. *Id.*

65. 999 F. Supp. 2d 1235, 1245–46 (W.D. Wash. 2014).

66. *Id.* at 1246.

Washington appears to require a showing that the policyholder was prejudiced,<sup>67</sup> a requirement absent from section 15.

Likewise, the Supreme Court of Vermont precluded an insurance carrier from asserting new defenses to coverage not asserted in its original denial letter on the grounds “that when an insurer ‘deliberately puts his refusal to pay on a specified ground, and says no more, he should not be allowed to “mend his hold” by asserting other defenses after the insured has taken him at his word and is attempting to enforce his liability.’”<sup>68</sup> Notably, the court intimated that it might be permissible for an insurance company to assert additional grounds not originally asserted in its denial if it includes a general reservation of the right to do so in its original denial.<sup>69</sup> As noted previously, however, the Restatement allows general reservations of rights only under limited circumstances.<sup>70</sup>

The mend the hold doctrine prevents an insurance company from denying coverage on one basis and then asserting new and different grounds for its denial when the original ground is challenged or fails. This principle of insurance law is reflected in the provisions of section 15. The Restatement overcomes the complexities of the mend the hold doctrine, avoiding difficult speculations using hindsight about what could and would have been, if the reservation on that particular ground for contesting coverage had been made in a proper and timely manner. By recognizing that an insurance company retains the right to contest coverage only on a ground that has been timely and properly reserved through intelligible notice to the policyholder, the Restatement properly creates a waiver of any grounds for contesting coverage that are not timely and properly reserved.

#### D. *Duty of Good Faith and Fair Dealing*

Although the implied duty of good faith and fair dealing exists in all contracts, it is especially important in insurance policies. Unlike other contracts, insurance policies are “not obtained for commercial advantage;” rather, they are procured to protect the policyholder in the event disaster strikes.<sup>71</sup> A motivating force underlying the purchase of insurance is peace of mind.<sup>72</sup>

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67. *Bosko v. Pitts & Still, Inc.*, 454 P.2d 229, 234 (Wash. 1969).

68. *Progressive Ins. Co. v. Brown ex rel. Brown*, 966 A.2d 666, 668 (Vt. 2008) (quoting *Cummings v. Conn. Gen. Life Ins. Co.*, 148 A. 484, 487 (Vt. 1930)).

69. *Id.* at 669.

70. See RESTATEMENT OF THE LAW OF LIAB. INS. § 15(d) (AM. LAW INST., Discussion Draft 2015).

71. *Best Place, Inc. v. Penn Am. Ins. Co.*, 920 P.2d 334, 342 (Haw. 1996) (“An insurance policy is not obtained for commercial advantage; it is obtained as protection against

As the Pennsylvania Supreme Court has explained,

by asserting in the policy the right to handle all claims against the insured, including the right to make a binding settlement, the insurer assumes a fiduciary position towards the insured and [b]ecomes obligated to act in good faith and with due care in representing the interests of the insured.<sup>73</sup>

This fiduciary position exists, regardless of whether the defense is assumed with or without reservation:

When an insurer defends its insured under a “reservation of rights,” the insurer is nearly a fiduciary of the insured. While in the liability coverage context, the insurer does not have to place the insured’s interests above its own interests, it must give “equal consideration” to the insured’s interests. This “enhanced obligation” to defend requires the insurance company to (1) thoroughly investigate the cause of the insured’s accident and the nature and severity of the plaintiff’s injuries, (2) retain competent defense counsel, recognizing that only the insured is the client, and (3) fully inform the insured not only of the reservation of rights defense itself, but of all developments relevant to his or her policy coverage and the progress of the lawsuit.<sup>74</sup>

In this vein, courts have invoked the duty of good faith and fair dealing where an insurance company has failed to issue a timely or proper reservation of rights. For example, a federal court in Illinois awarded attorneys’ fees and other extra-contractual damages under a state statute that permits the award of such damages where an insurance company’s behavior is “vexatious and unreasonable” because

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calamity.” (quoting *Noble v. Nat’l Am. Life Ins. Co.*, 624 P.2d 866, 867 (Ariz. 1981) (in banc)).

72. *Spencer v. Aetna Life & Cas. Ins. Co.*, 611 P.2d 149, 152 (Kan. 1980) (“[W]hen an insured purchases insurance, he is purchasing more than financial security; he is purchasing peace of mind.”).

73. *Gray v. Nationwide Mut. Ins. Co.*, 223 A.2d 8, 11 (Pa. 1966) (quoting *Gedeon v. State Farm Mut. Auto. Ins. Co.*, 188 A.2d 320, 322 (Pa. 1963)).

74. *Ki Sin Kim v. Allstate Ins. Co.*, 223 P.3d 1180, 1192 (Wash. Ct. App. 2009) (citations omitted). As recognized by the Washington Supreme Court in an en banc decision, the enhanced fiduciary duty of an insurance company to a policyholder when defending under a reservation of rights stems from the conflict of interest “inherent” in a carrier’s defense under a reservation of rights. *Tank v. State Farm Cas. Co.*, 715 P.2d 1133, 1137 (Wash. 1986) (en banc).

the insurance company failed to timely issue a reservation of rights.<sup>75</sup> The court determined that the insurance company's two-year delay in issuing a reservation of rights—delaying denial until the eve of trial—met the vexatious and unreasonable standard.<sup>76</sup> The carrier received regular updates on the underlying case and the claims handler made notations in the claims file about doubts as to coverage.<sup>77</sup> The insurance company's claims handler acknowledged that “one of the primary rights of an insured is to know if there is no coverage under a given policy.”<sup>78</sup>

Further, a North Carolina intermediate appellate court upheld the trial court's bad faith finding and award of treble damages where an insurance company “unfairly” and “improperly” sent a reservation of rights letter based on the liquor liability exclusion in the policy without having “an adequate or documented basis to reverse [the claims handler's] position to not reserve rights.”<sup>79</sup> After all, because “an insurer is in the business of analyzing and allocating risk[,] [it] is in the best position to assess the viability of [these] coverage dispute[s]”<sup>80</sup> and failing to properly investigate a claim, while it simultaneously retains the power to control the defense, is a breach of the implied good faith covenant in the policy it sold.<sup>81</sup>

The implied contractual duty of good faith supports the provision in section 15(1) requiring an insurance company to raise any grounds for contesting coverage of which it knows *or should know*. A reservation of rights letter does not absolve an insurance company from conducting a thorough investigation of the facts as they apply to the language of the policy. Indeed, an insurance company's duty to investigate is part and parcel of the covenant of good faith and fair dealing. Under California law, for instance, “[w]hile an insurance company has no obligation under the implied covenant of good faith and fair dealing to pay every claim its insured makes, the insurer cannot deny the claim ‘without fully investigating the grounds for its denial.’”<sup>82</sup> To protect the policyholder's “peace of mind, ‘it is essential that an insurer fully inquire into possible

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75. *Am. Safety Cas. Ins. Co. v. City of Waukegan*, 776 F. Supp. 2d 670, 704 (N.D. Ill. 2011), *aff'd*, 678 F.3d 475 (7th Cir. 2012).

76. *Id.* at 704–05.

77. *Id.* at 704.

78. *Id.*

79. *Country Club of Johnston Cty., Inc. v. U.S. Fid. & Guar. Co.*, 563 S.E.2d 269, 279 (N.C. Ct. App. 2002).

80. *U.S. Fid. & Guar. Co. v. U.S. Sports Specialty Ass'n*, 270 P.3d 464, 471 (Utah 2012) (alterations in original) (quoting *Tex. Ass'n of Ctys. Cty. Gov't Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 135 (Tex. 2000)).

81. *Romano v. Nationwide Mut. Fire Ins. Co.*, 646 A.2d 1228, 1232 (Pa. Super. Ct. 1994).

82. *Wilson v. 21st Century Ins. Co.*, 171 P.3d 1082, 1087 (Cal. 2007) (quoting *Frommoethelydo v. Fire Ins. Exch.*, 721 P.2d 41, 44 (Cal. 1986) (in bank)).

bases that might support the insured's claim' before denying it."<sup>83</sup> "By the same token, denial of a claim on a basis unfounded in the facts known to the insurer, or contradicted by those facts, may be deemed unreasonable."<sup>84</sup>

*E. Reasonable Expectations*

Professor, later Judge, Robert Keeton drafted the seminal work on the reasonable expectations doctrine more than forty years ago.<sup>85</sup> Professor Keeton defined and advocated the doctrine as follows: "The objectively reasonable expectations of applicants and intended beneficiaries regarding the terms of insurance contracts will be honored even though painstaking study of the policy provisions would have negated those expectations."<sup>86</sup> The doctrine "protect[s] the policyholder's expectations as long as they are objectively reasonable from the layman's point of view, in spite of the fact that had he made a painstaking study of the contract, he would have understood the limitation that defeats the expectations at issue."<sup>87</sup> Insurance companies may not apply exclusions to coverage that are contrary to the expectations of the policyholder unless the insurance company calls the exclusion to the attention of the policyholder at the time of sale:

An important corollary of the expectations principle is that insurers ought not to be allowed to use qualifications and exceptions from coverage that are inconsistent with the reasonable expectations of a policyholder having an ordinary degree of familiarity with the type of coverage involved. This ought not to be allowed even though the insurer's form is very explicit and unambiguous, because insurers know that ordinarily policyholders will not in fact read their policies. Policy forms are long and complicated and cannot be fully understood without detailed study; few policyholders ever read their policies as carefully as would be required for moderately detailed understanding. Moreover, the normal processes for marketing most kinds of insurance do not ordinarily place the detailed policy terms in the hands of the policyholder until the contract has

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83. *Id.* (quoting *Egan v. Mut. of Omaha Ins. Co.*, 620 P.2d 141, 145 (Cal. 1979) (in bank)).

84. *Id.*

85. Robert E. Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961 (1970).

86. *Id.* at 967.

87. *Id.*

already been made. . . . Thus, not only should a policyholder's reasonable expectations be honored in the face of difficult and technical language, but those expectations should prevail as well when the language of an unusual provision is clearly understandable, unless the insurer can show that the policyholder's failure to read such language was unreasonable.

It is important to note, however, that the principle of honoring reasonable expectations does not deny the insurer the opportunity to make an explicit qualification effective by calling it to the attention of a policyholder at the time of contracting, thereby negating surprise to him.<sup>88</sup>

The Pennsylvania Supreme Court has explained the reasonable expectations doctrine in the following way:

The reasonable expectation of the insured is the focal point of the insurance transaction involved here. . . . Courts should be concerned with assuring that the insurance purchasing public's reasonable expectations are fulfilled. Thus, regardless of the ambiguity, or lack thereof, inherent in a given set of insurance documents (whether they be applications, conditional receipts, riders, policies, or whatever), the public has a right to expect that they will receive something of comparable value in return for the premium paid. Courts should also keep alert to the fact that the expectations of the insured are in large measure created by the insurance industry itself. Through the use of lengthy, complex, and cumbersomely written applications, conditional receipts, riders, and policies, to name just a few, the insurance industry forces the insurance consumer to rely upon the oral representations of the insurance agent. Such representations may or may not accurately reflect the contents of the written document and therefore the insurer is often in a position to reap the benefit of the insured's lack of understanding of the transaction.

. . . .

Courts must examine the dynamics of the insurance transaction to ascertain what are the reasonable expectations of the consumer. . . . Courts must also keep in mind the obvious

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88. *Id.* at 968.

advantages gained by the insurer when the premium is paid at the time of application. An insurer should not be permitted to enjoy such benefits without giving comparable benefit in return to the insured.<sup>89</sup>

When an insurance company assumes the defense without reservation of any right to contest coverage, a policyholder reasonably expects that the insurance company will pay any settlement or judgment.<sup>90</sup> When an insurance company defends under a reservation of rights to contest coverage on certain specified grounds, a policyholder reasonably expects that the insurance company will pay any settlement or judgment if the settlement or judgment does not implicate the grounds stated as a basis for denying or limiting coverage.<sup>91</sup> Likewise, if an insurance company denies coverage, the policyholder reasonably expects that the insurance contract does not limit its actions in any way, and if the insurance company is wrong in its disclaimer, the insurance company will pay all damages flowing from the disclaimer. As to all of these scenarios, the Restatement properly reflects an appreciation of the expectations of policyholders and seeks to fulfill them.

#### F. Other Considerations

##### 1. Waiver of Conditions, Exclusions, and Coverage Provisions

Some courts have made distinctions between whether coverage can be “expanded” by waiver or estoppel. Such courts may draw distinctions between waiver and estoppel and between the “terms” of coverage and the “conditions” for seeking coverage. The Restatement, properly, makes no such distinctions.<sup>92</sup>

Under New York law, an insurance company’s act of disclaiming on certain grounds but not others is deemed conclusive evidence of the

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89. *Tonkovic v. State Farm Mut. Auto. Ins. Co.*, 521 A.2d 920, 926 (Pa. 1987) (quoting *Collister v. Nationwide Life Ins. Co.*, 388 A.2d 1346, 1353–54 (Pa. 1978)).

90. *See N.C. Farm Bureau Mut. Ins. Co. v. Fowler ex rel. Rudisill*, 589 S.E.2d 911, 914 (N.C. Ct. App. 2004).

91. *See, e.g., Scottsdale Ins. Co. v. City of Hazleton*, No. 3:07–CV–1704, 2009 WL 1507161, at \*11 (M.D. Pa. May 28, 2009) (rejecting the policyholder’s argument that invocation of policy exclusion contravened its reasonable expectations of coverage where the carrier raised exclusion in a reservation of rights letter); *Fowler*, 589 S.E.2d at 914 (using the reasonable expectations doctrine to affirm the trial court’s grant of summary judgment to the insurer on the ground that, because the insurer defended under full reservation of rights, the policyholder could have had no reasonable expectation that the insurer would pay costs incurred in defending suit for which there was no coverage).

92. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 15 cmt. b (AM. LAW INST., Discussion Draft 2015).

insurance company's intent to waive the unasserted grounds.<sup>93</sup> In *Albert J. Schiff Associates, Inc. v. Flack*, however, the New York Court of Appeals held that the doctrine of waiver was inapplicable to the assertion of exclusions because an expansion of coverage cannot be achieved by waiver.<sup>94</sup> The court viewed "coverage" under the policy to be a coming together of both insuring agreement and exclusions, which together define the scope of the protection afforded.<sup>95</sup> Accordingly, the court reasoned that to allow waiver of an exclusion would constitute an impermissible expansion of coverage.<sup>96</sup> The reasoning of *Schiff* was undermined twenty years later, however, when the New York Court of Appeals heard the case *Worcester Insurance Co. v. Bettenhauser*, holding that an exclusion could be waived, at least under New York statutory law when applicable, based on untimely disclosure.<sup>97</sup> The court cited its precedent decided subsequent to *Schiff* holding that "the carrier must deny coverage on the basis of the exclusion if it is not to mislead the insured and the injured person to their detriment."<sup>98</sup>

New York courts have always allowed estoppel (as opposed to waiver) against an insurance company based upon untimely reservation or disclaimer under the common law, regardless of whether the insurance company is being estopped from asserting "terms of coverage" provisions or conditions.<sup>99</sup> However, establishing estoppel involves proof of detrimental reliance or prejudice. In contrast, the Restatement recognizes the insurance company's duty to timely reserve rights on all grounds that are being used to contest coverage, regardless of whether those grounds are based upon the grant of coverage, exclusions, the conditions of coverage, or otherwise. The Restatement recognizes that the failure to reserve rights on any particular ground means that such ground for contesting coverage is simply not reserved for later assertion.

Properly viewed, coverage is not "expanded" through waiver; rather, the insurance company is simply prohibited from contesting coverage on any grounds not properly reserved.

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93. *New York v. AMRO Realty Corp.*, 936 F.2d 1420, 1432 (2d Cir. 1991).

94. 417 N.E.2d 84, 87 (N.Y. 1980).

95. *Id.* at 86.

96. *See id.* at 87; *see also* *N.Y. Univ. v. Cont'l Ins. Co.*, 662 N.E.2d 763, 772 (N.Y. 1995) (noting that no waiver of right to disclaim coverage based on application of policy exclusion exists).

97. 734 N.E.2d 745, 748 (N.Y. 2000).

98. *Id.* (quoting *Zappone v. Home Ins. Co.*, 432 N.E.2d 783, 786 (N.Y. 1982)).

99. *N.Y. Univ.*, 662 N.E.2d at 772 ("While the insurer may waive the right to disclaim based on the insured's noncompliance with a condition precedent, its right to disclaim coverage based on a policy exclusion can be defeated only by estoppel." (citation omitted)).

## 2. Obligation to Reserve Rights when Defense Is Not Assumed

The Restatement creates a duty to speak in the form of a timely and substantively sufficient reservation of rights when the insurance company “undertakes” the duty to defend. This does not address whether there is a duty to speak in other contexts, such as (1) when the insurance company is disclaiming coverage entirely and therefore disclaiming its duty to defend; and (2) when the insurance company has the right to associate in the defense as described in section 23 of the Restatement.

When the insurance company is disclaiming coverage entirely, the *hold* doctrine, if applied rigorously, should be sufficient to prevent an insurance company from later shifting the grounds for disclaimer. The insurance company owes the policyholder, who paid premium for the protection of the insurance, a full and complete explanation of the grounds for disclaimer so the policyholder can promptly address those grounds by providing additional facts, argument, or law to contradict the disclaimer. The insurance company would have a duty to consider such information under the implied covenant of good faith and fair dealing. Providing prompt notice of the full grounds for disclaimer also allows the policyholder to decide whether to pursue court intervention through a breach of contract, declaratory judgment, or bad faith lawsuit. State insurance statutes and regulations may also require insurance companies to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for the denial of a claim. Such statutes and regulations may be privately actionable or may provide evidence of bad faith.

Insurance companies with the right to associate in the defense of the claim also should promptly and fully present any grounds for contesting coverage. Insurance companies with the right to associate in the defense of the claim have the right to be provided with information, with the exception of confidential information, that relates to an actual or potential coverage dispute.<sup>100</sup> The formulation of this rule assumes that the policyholder has been appropriately informed of the actual or potential coverage dispute. If not so advised, the policyholder would be unable to protect its confidential information as contemplated by section 23.

Indeed, an insurance company that has an obligation to provide an independent defense under section 16 of the Restatement does not assume the defense; yet, the basis for determining the obligation to provide an independent defense is explicitly tied to the reservation of

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100. RESTATEMENT OF THE LAW OF LIAB. INS. § 23(1)(a) (AM. LAW INST., Discussion Draft 2015).

rights owed in section 15. Thus, the duty to reserve rights extends beyond the situation where the insurance company actually *assumes* the defense.

Section 22 confirms the thesis that the duty to reserve rights extends beyond the situation in which the defense is being assumed by the insurance company. Under section 22, a defense cost indemnification policy is defined as “a[] [liability] insurance policy in which the insurer agrees to pay the costs of defense of a covered claim and does not undertake the duty to defend.”<sup>101</sup> Section 15 of the Restatement ties the obligation to reserve rights to the insurance company undertaking the duty to defend.<sup>102</sup> Thus, one would think that an insurance company issuing a defense cost indemnification policy would have no duty to reserve rights if that duty were tied to the undertaking of the defense. Yet, the Restatement makes a different choice, stating that “[t]o preserve the right to contest coverage for a claim, the insurer must follow the procedure stated in § 15.”<sup>103</sup> Comment b to section 22 explains that the justifications for requiring a proper reservation of rights in a defense cost indemnification policy are not as strong; yet, the rule is necessary to protect the reasonable expectations of the policyholder when the defense is paid on an ongoing basis.<sup>104</sup> Comment c to the Restatement notes that most courts that considered the issue have treated the breach of the duty to pay defense costs on an ongoing basis identically to a breach of the duty to defend.<sup>105</sup>

### 3. Excess Insurance

One area of recent activity in the case law, which is undecided in nearly all jurisdictions, is the duty of excess insurance companies to reserve their rights promptly upon receipt of notice.<sup>106</sup> Excess insurance companies may issue duty to defend policies or defense cost indemnification policies, within the meaning of those terms in the Restatement.

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101. *Id.* § 22(1).

102. *Id.* § 15(1).

103. *Id.* § 22(2)(b).

104. *Id.* § 22 cmt. b.

105. *Id.* § 22 cmt. c.

106. *See, e.g.*, *Cincinnati Ins. Co. v. All Plumbing, Inc. Serv., Parts Installation*, 983 F. Supp. 2d 162, 168–69 (D.D.C. 2013) (predicting District of Columbia law); *TIG Ins. Co. v. Tyco Int’l Ltd.*, 919 F. Supp. 2d 439, 458 (M.D. Pa. 2013) (predicting Pennsylvania law). Note that the principle of *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938) applies to federal courts in the District of Columbia when they are predicting “state” law in the District of Columbia. *Friends for All Children, Inc. v. Lockheed Aircraft Corp.*, 746 F.2d 816, 824 (D.C. Cir. 1984).

The duty of an excess insurance company to defend or pay a share of the defense costs typically does not arise, under the policy language, until the underlying insurance has been exhausted.<sup>107</sup> However, under an umbrella form excess policy, the umbrella carrier typically will be required to “drop down” and assume the defense obligation if the umbrella insurance policy potentially provides coverage and the primary insurance company does not assume the defense.<sup>108</sup> Moreover, an excess insurance company may agree to indemnify for all or—more likely—a pro rata share of defense costs to the extent that a judgment or settlement reaches its layer. Alternatively, equitable principles could compel excess insurance payment of a portion of defense costs.<sup>109</sup> Indeed, when an excess insurance company is confronted with a settlement demand that places its coverage at stake, the law is well settled that at least certain aspects of its duty to defend arise, including its duty to make reasonable settlement decisions.<sup>110</sup>

Because the excess insurance company’s defense-related duties, including the duty to make reasonable settlement decisions under section 24 of the Restatement and the duty to pay for the defense under section 22 of the Restatement, can arise under many different scenarios, it is important that an excess insurance company promptly and fully reserve its rights in a manner that meets both the Timing Requirement and Content Requirement set forth in section 15 of the Restatement.<sup>111</sup> Indeed, a primary purpose of a reservation of rights is to provide the policyholder with the clearest possible picture of how its insurance will respond to a claim. An excess insurance company should promptly and fully disclose its grounds for contesting coverage, if any, so that all insurance companies and parties—including the underlying claimant, who typically has rights to some insurance information under discovery rules—can move the case toward an appropriate and timely resolution based upon the liability and damages evaluations of counsel.<sup>112</sup> For many

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107. *Schneider Nat’l Transp. v. Ford Motor Co.*, 280 F.3d 532, 538 (5th Cir. 2002).

108. *Legacy Vulcan Corp. v. Superior Court*, 110 Cal. Rptr. 3d 795, 803–04 (Ct. App. 2010).

109. *Gen. Accident Ins. Co. of Am. v. Safety Nat’l Cas. Corp.*, 825 F. Supp. 705, 706 (E.D. Pa. 1993).

110. *Cooper Labs., Inc. v. Int’l Surplus Lines Ins. Co.*, 802 F.2d 667, 676 (3d Cir. 1986); *cf. Associated Wholesale Grocers, Inc. v. Americold Corp.*, 934 P.2d 65, 91 (Kan. 1997) (“[T]he excess carrier may have to decide coverage instantaneously when a settlement is demanded. The noninvestigating carrier may be unprepared.”).

111. In *Rummel v. Lexington Insurance Co.*, the New Mexico Supreme Court stated that an excess insurer might bear liability for bad faith if it refuses to participate in settlement negotiations, even absent a duty to defend. 945 P.2d 970, 984 (N.M. 1997).

112. Some courts have tied the insurance company’s obligations to whether the policyholder’s potential liability will, may, or will not require coverage from the excess

claims, the excess insurance contributions to a settlement or judgment will dwarf the contribution from the primary insurance.

Some courts have been reluctant to apply estoppel when an excess insurance company is alleged to have failed to timely reserve its rights, linking the duty to reserve rights *exclusively* to the assumption of the defense.<sup>113</sup> However, even in those cases, courts often note that estoppel could arise based upon the particular facts and circumstances: “[I]f it is the custom to issue a reservation of rights letter between an [insurance company] and its [policyholder], this custom could give rise to an estoppel if it is detrimentally relied upon by the [policyholder].”<sup>114</sup>

These cases reflect a logical fallacy; they note that the duty to reserve rights arises upon the assumption of the defense, and then *presume* that absent such assumption, there is no duty to speak. However, the duty to reserve rights arises upon the assumption of the defense *and* arises in other contexts as well. Those other contexts include, quite explicitly in section 22, where the insurance company has an ongoing duty to reimburse defense costs rather than a duty to assume the defense.<sup>115</sup> Implicitly, those other contexts also include cases where the insurance company is obligated to provide an independent defense and where the insurance company has the right to associate in the defense of the claim. Excess insurance policies typically include the right to associate in the defense.

### III. SECTION 25. THE EFFECT OF A RESERVATION OF RIGHTS ON SETTLEMENT RIGHTS AND DUTIES

Section 25 of the Restatement sets forth the effect of a reservation of rights on a critical aspect of the defense obligation: the obligation to settle a case reasonably and in good faith:

- (1) A reservation of the right to contest coverage does not relieve an insurer of the duty to make reasonable settlement decisions stated in § 24.
  
- (2) Unless otherwise stated in a[] [liability] insurance policy or agreed to by the insured, an insurer may not settle a

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policy. *See, e.g.*, Keck, Mahin & Cate v. Nat’l Union Fire Ins. Co. of Pittsburgh, 20 S.W.3d 692, 700–01 (Tex. 2000).

113. *See, e.g.*, Cincinnati Ins. Co. v. All Plumbing, Inc. Serv., Parts Installation, 983 F. Supp. 2d 162, 169 (D.D.C. 2013); Montgomery Ward & Co. v. Home Ins. Co., 753 N.E.2d 999, 1006 (Ill. App. Ct. 2001).

114. *Montgomery Ward & Co.*, 753 N.E.2d at 1006.

115. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 22(1) (AM. LAW INST., Discussion Draft 2015).

claim and thereafter demand recoupment of the settlement amount from the insured on the grounds that the claim was not covered.

- (3) When an insurer has reserved the right to contest coverage for a claim, the insured may settle the claim without the consent of the insurer and without violating the duty to cooperate or other restrictions on the insured's settlement rights contained in the policy, provided the following requirements are met:
  - (a) The insurer is given the opportunity to participate in the settlement process;
  - (b) The insurer declines to withdraw its reservation of rights after receiving prior notice of the proposed settlement;
  - (c) A reasonable person that bore the sole financial responsibility for the full amount of the potential covered judgment would have accepted the settlement; and
  - (d) If the settlement includes payments for damages that are not covered by the liability insurance policy, the portion of the settlement allocated to the insured component of the claim is reasonable.<sup>116</sup>

Under the Restatement, an insurance company defending under a reservation of rights remains obligated to make reasonable settlement decisions, which requires the insurance company to settle a claim when it is reasonable to do so. When the insurance company defending under a reservation of rights does not agree to a proposed settlement, its conduct will be judged under the standards of sections 24 and 27 of the Restatement, which set forth the duty to make reasonable settlement decisions and the damages for the breach of that duty. Furthermore, when the insurance company defending under a reservation of rights does not agree to the proposed settlement, the policyholder may still settle the claim, if the requirements of section 25 are met.

When an insurance company defending under a reservation of rights pays for the settlement, it will not be permitted to obtain reimbursement

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116. *Id.* § 25.

from the policyholder unless otherwise stated in a liability insurance policy or agreed by the insured.<sup>117</sup> This is generally consistent with the existing case law<sup>118</sup> and the anti-subrogation rule that prevents an insurance company from recovering settlements and judgments paid under the insurance policy from its own insureds.<sup>119</sup> Essentially, the payment of the settlement acts as a withdrawal of the reservation of rights, or put another way, it acts as a decision not to assert the rights that had been reserved. When an insurance company agrees to the settlement, but does not pay for it, the policyholder will either have to pay the settlement amount and seek to recover from the insurance company or assign the right to recover the settlement to the underlying claimant, who will then seek to recover from the insurance company. Under section 27 of the Restatement, the policyholder may also assign the claim for breach of the duty to settle.

If an insurance company is defending an action *without* reservation, the insurance company will typically retain control over the decision of whether or not to settle, with its decision to settle or not settle being evaluated under the standard of section 24—governing the duty to make reasonable settlement decisions—and with the consequences of those decisions being reflected in section 27—governing the damages for breach of the duty to make reasonable settlement decisions.

#### IV. SECTION 18. TERMINATING THE DUTY TO DEFEND A CLAIM

Under section 18, a final adjudication that the insurance company does not have a duty to defend the claim is one means of terminating the duty to defend.<sup>120</sup> Comment j to section 18 explains that the insurance company defending under a reservation of rights may avoid the continued duty to defend through a declaratory judgment action, which is adjudicated on the basis of all of the relevant facts or circumstances, not just on the facts alleged.<sup>121</sup> The Restatement states that “the insurer may

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117. *Id.* § 25(2).

118. *Tex. Ass’n of Ctys. Cty. Gov’t Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 131–33 (Tex. 2000); *Utica Mut. Ins. Co. v. Rohm & Haas Co.*, 683 F. Supp. 2d 368, 372–73 (E.D. Pa. 2010).

119. *Remy v. Michael D’s Carpet Outlets*, 571 A.2d 446, 447 (Pa. Super. Ct. 1990) (“By definition, subrogation can arise only with respect to the rights of an insured against third persons to whom the insurer owes no duty. It follows and, indeed, is now well established that an insurer cannot recover by means of subrogation against its own insured.” (citations omitted)).

120. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 18(2) (AM. LAW INST., Discussion Draft 2015).

121. *Id.* § 18 cmt. j.

prove that the claim is excluded because the insured's conduct falls within the scope of an exclusion in the policy."<sup>122</sup>

This is extremely troublesome if it puts the insurance company in the position of proving facts adverse to the insured that could advantage the underlying claimant or undermine the fundamental purpose of the insurance. For example, an insurance company cannot be permitted to bring a declaratory judgment action to prove that its insured caused bodily injury or property damage *intentionally* when the pleading alleges the policyholder caused such injury or damage *negligently*. If that were permitted, the insurance company could be defending claims of negligence under a reservation of rights while simultaneously proving an intentional tort against its policyholder in a separate declaratory judgment action as a means of disclaiming its continuing duty to defend the claims of negligence. The claims of negligence are the only claims brought and, if proven, would be covered.

A modification to illustration 4 of section 18 reveals the problem.<sup>123</sup> In that illustration, an "[i]nsured child is sued for property damage arising out of a fire allegedly started by the child at school. The complaint alleges that the child negligently caused the fire while playing with matches."<sup>124</sup> An investigation causes the insurance company "to believe that the child may have started the fire on purpose."<sup>125</sup> Could the insurance company defend the complaint for negligence under a reservation of rights by providing an independent defense under section 18<sup>126</sup> while, at the same time, bringing a declaratory judgment action not only to prove that the child started the fire, but also that he or she did so intentionally? It seems clear that the insurance company could not in good faith bring such an action, but the Restatement does not clearly reject that approach.

Although the Restatement may encourage the filing of declaratory judgment actions in certain circumstances, the Restatement does not *require* the filing of declaratory judgment actions in any situation. Although commonplace, declaratory judgments should be disfavored. A policyholder pays premiums for insurance, not to finance an insurance company's insurance coverage lawsuits against the policyholder. When a policyholder pays its premiums up front it has a right to expect insurance

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122. *Id.*

123. Illustration 4 repeats a fact pattern used in several sections of the Restatement.

124. *Id.* § 18 cmt. j, illus. 4.

125. *Id.*

126. The insurance company would be required to provide an independent defense in this situation under section 16. In illustration 1 to section 19, the Restatement posits a factual scenario where the insurance company declined to provide an independent defense to the child. *Id.* § 19 cmt. a, illus. 1. In a subsequent breach of contract action, the only question is whether the insurance company "breached the duty to defend by failing to provide an independent defense, without regard to whether the child . . . started the fire." *Id.*

coverage when a claim is made, “not a lot of vexatious, time-consuming, expensive litigation with [the insurance company].”<sup>127</sup> A declaratory judgment action requires a policyholder to pay litigation expenses, undermining one fundamental purpose of liability insurance: to protect the policyholder from legal expense. Insurance companies sometimes claim they need guidance from a court about how their coverage applies, but the insurance company should be able to make its own coverage determination, and if its insurance policy is ambiguous or there is any uncertainty about whether there may be coverage, then the insurance company should err in favor of providing coverage, at least under a reservation of rights.<sup>128</sup>

#### V. SECTION 19. CONSEQUENCES OF BREACH OF THE DUTY TO DEFEND

Section 19 of the Restatement details the consequences of an insurance company’s “ordinary”<sup>129</sup> breach of its duty to defend:

- (1) An insurer that breaches the duty to defend a claim loses the right to assert any control over the defense or settlement of the claim and the right to contest coverage for the claim.
- (2) Damages for breach of the duty to defend include the amount of any judgment entered against the insured or the reasonable portion of a settlement entered into by or on behalf of the insured after breach, subject to the policy limits, and the reasonable defense costs incurred by or on behalf of the insured, in addition to any other damages recoverable for breach of a liability insurance contract.

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127. *Hayseeds, Inc. v. State Farm Fire & Cas.*, 352 S.E.2d 73, 79 (W. Va. 1986).

128. *See* *George F. Hillenbrand, Inc. v. Ins. Co. of N. Am.*, 128 Cal. Rptr. 2d 586, 600 (Ct. App. 2002) (“There is no support in the cases for the insurer’s notion that a declaratory relief action affords an insurer a convenient vehicle for determination of coverage issues, limited only by a standard that the action not be frivolous. To the contrary, the cases suggest declaratory relief actions are disfavored because of the practical difficulties they create for an insured that must defend against two actions simultaneously.”); *Shoshone First Bank v. Pac. Emp’rs Ins. Co.*, 2 P.3d 510, 516 (Wyo. 2000) (“The question as to whether there is a duty to defend an insured is a difficult one, but because that is the business of an insurance carrier, it is the insurance carrier’s duty to make that decision.”).

129. The principles stated in section 19 address an “ordinary” breach, recognizing that additional damages may be available in the event of bad faith. RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. g (AM. LAW INST., Discussion Draft 2015).

- (3) The insured may assign to the claimant or to an insurer that takes over the defense all or part of any cause of action for breach of the duty to defend the claim.<sup>130</sup>

A. *Forfeiture of the Right to Defend*

As previously noted, an insurance company presented with a liability claim may defend without reservation, defend under a reservation, or disclaim any defense obligation. Section 19(1) recognizes that a consequence of disclaiming the *duty* to defend will be the forfeiture of the *right* to defend. The insurance company's right to defend is outlined in section 10 of the Restatement and includes "[t]he authority to direct all the activities of the defense of any claim that the insurer has a duty to defend, including the selection and oversight of defense counsel."<sup>131</sup> Section 23 of the Restatement addresses the "Right to Associate in the Defense of a Claim," which includes the right to receive information and to be consulted regarding major decisions in the defense of the claim.<sup>132</sup> Section 19(1) explicitly states that those rights of the insurance company are lost upon its breach of the duty to defend.

Accordingly, when an insurance company breaches its defense obligation, it forfeits its right to exert any control over the defense. This principle accords with precedent. For instance, after holding that an insurance company had failed to defend underlying lawsuits pending against its policyholder in contravention of language in the policy it sold, an intermediate appellate court in Louisiana rejected the insurance company's argument that it was entitled to control the selection of underlying defense counsel going forward.<sup>133</sup>

Likewise, a case decided by the North Carolina Supreme Court applied the *hold* doctrine to prevent the insurance company from asserting its right to defend after disclaiming all coverage.<sup>134</sup> The insurance company denied any duty to defend for either personal injury or property damage, then offered to withdraw the denial of liability for personal injury while maintaining a denial for property damage.<sup>135</sup> The insurance company asserted the right "to have complete control of the case."<sup>136</sup> The policyholder declined to cede control of the defense, so the

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130. *Id.* § 19.

131. *Id.* § 10(1).

132. *Id.* § 23.

133. *Smith v. Reliance Ins. Co. of Ill.*, 807 So. 2d 1010, 1022 (La. Ct. App. 2002).

134. *Standard Accident Ins. Co. v. Harrison-Wright Co.*, 178 S.E. 235, 241 (N.C. 1935).

135. *Id.*

136. *Id.*

insurance company disclaimed all liability again.<sup>137</sup> The court permitted the policyholder to rely on the first denial of coverage.<sup>138</sup> In reaching its decision, the court recognized that an insurance company with complete control of the case, having already denied coverage, would be incentivized to take a position in the underlying litigation that would reduce the policyholder's insurance coverage.<sup>139</sup> The lawyers retained by the policyholder were successful in having the jury find no personal injury,<sup>140</sup> so the insurance company's attorneys could have done no better. It is unclear whether this lack of prejudice was dispositive in the court's decision regarding the mend the hold doctrine. Later in the opinion, however, the court noted the rule that "[t]he failure of the defendant to defend the suit, after repudiating its liability to the assured, constituted distinct breach of contract and justified the plaintiff in defending it at his own expense."<sup>141</sup> This latter, clear rationale is more consistent with the Restatement approach. Once the duty to defend is breached, the right to defend and the right to associate in the defense are forfeited.

#### *B. Loss of the Right to Control Settlement*

Insurance policies typically provide that the policyholder may not settle an action without the written consent of the insurance company. Where the insurance company breaches its duty to defend, however, it cannot exert any control over the decision to settle or in what amount. The remedy for breach of a duty to defend includes, under section 19(2), only the "reasonable portion of a settlement entered into by or on behalf of the insured after breach, subject to the policy limits."<sup>142</sup>

This "reasonable portion" language begs an important question: which party bears the burden to show that the settlement amount is reasonable or unreasonable or what "portion" is reasonable or unreasonable? Under California law, if a carrier wrongfully denies coverage or refuses to provide a defense, the policyholder is free to negotiate a settlement with the plaintiff, and that settlement creates an evidentiary presumption of liability and damages for purposes of a subsequent action against the carrier to enforce the settlement.<sup>143</sup> The burden then shifts to the carrier to prove by a preponderance of the

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137. *Id.*

138. *Id.*

139. *Id.*

140. *Id.*

141. *Id.* at 242 (citing *St. Louis Dressed Beef & Provision Co. v. Md. Cas. Co.*, 201 U.S. 173 (1906)).

142. RESTATEMENT OF THE LAW OF LIAB. INS. § 19(2) (AM. LAW INST., Discussion Draft 2015).

143. *Pruyn v. Agric. Ins. Co.*, 42 Cal. Rptr. 2d 295, 303 (Ct. App. 1995).

evidence that the stipulated judgment was the product of fraud or collusion—i.e., not in good faith.<sup>144</sup> Unless the carrier can meet that burden of proof, it is bound by the stipulated judgment.<sup>145</sup> As a matter of public policy, the burden of proof “should fall upon the insurer whose breach has occasioned the settlement.”<sup>146</sup> In comment d to section 19, the Restatement makes clear that the insurance company bears the burden to show which portion, if any, of the settlement amount is unreasonable.<sup>147</sup>

Indeed, it is highly questionable whether “reasonableness” is a reasonable standard. An insurance company that breaches its duty to defend should not be heard to second-guess whether its policyholder defended or settled the action “reasonably.” An insurance company should not be permitted to relitigate the underlying case when it was obligated to, but failed to, defend that case in the first place. The proper course is to preclude entirely any inquiry into the reasonableness of the settlement, absent compelling proof of fraud, when the insurance company has breached its duty to defend.<sup>148</sup> If a carrier is confident enough to make a unilateral determination that it has no duty to defend, then the amount reached in any settlement by its policyholder should be of no consequence. If the carrier’s claim of nonliability is correct, a settlement amount of zero dollars or one billion dollars would have the same effect.<sup>149</sup> If there is *any* doubt about the defense obligation, the insurance company should defend under a reservation of rights.

### C. No Right to Contest Coverage for the Claim

The loss of the right to contest coverage for the claim is a necessary remedy to prevent insurance companies from breaching the duty to

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144. *Id.* at 313–14.

145. *Id.* at 314.

146. *Id.* at 313 (quoting *Xebec Dev. Partners, Ltd. v. Nat’l Union Fire Ins. Co. of Pittsburgh*, 15 Cal. Rptr. 2d 726, 752 (Ct. App. 1993)).

147. RESTATEMENT OF THE LAW OF LIAB. INS § 19 cmt. d (AM. LAW INST., Discussion Draft 2015) (placing the burden of proof on the insurance company because it has greater expertise in valuing claims and because it discourages breach of the duty to defend).

148. See *Parking Concepts, Inc. v. Tenney*, 83 P.3d 19, 22 n.3 (Ariz. 2004) (en banc) (noting that, where a carrier breaches its duty to defend, it “has no right to contest the stipulated damages on the basis of reasonableness, but rather may contest the settlement only for fraud or collusion”); *Evanston Ins. Co. v. ATOFINA Petrochemicals, Inc.*, 256 S.W.3d 660, 671 (Tex. 2008) (concluding that an insurance company that wrongfully denies coverage “is barred from challenging the reasonableness of the settlement amount” of its policyholder’s stipulated judgment).

149. See *Metcalf v. Hartford Accident & Indem. Co.*, 126 N.W.2d 471, 476 (Neb. 1964) (noting that an insurer’s failure to defend is of no consequence “if its claim of nonliability is correct”).

defend. Under section 15, an insurance company that undertakes the defense of a claim may later contest coverage for the claim only if it has provided a reservation of rights that meets the Timing Requirement and the Content Requirement of section 15.<sup>150</sup> An insurance company that disclaims coverage entirely has made a determination that there is no possibility of coverage. By doing so, and abandoning the policyholder to fend for itself, the insurance company has forfeited all grounds to contest coverage. Instead, it can only litigate its disclaimer of the duty to defend. Any other rule could incentivize an insurance company to disclaim the duty to defend, rather than to defend under a reservation of rights.

Indeed, the Restatement calls this the “better rule” because it properly incentivizes the insurance company to fulfill its duty to defend, recognizing that “[a]n insurer that could refuse to defend but still preserve its coverage defenses would be less willing to provide the promised defense.”<sup>151</sup> Without that remedy, a meritless disclaimer could be more cost-effective than performing an investigation and defending under a timely and proper reservation of rights.<sup>152</sup>

As referenced in the Reporters’ Note, this rule has traditionally been grounded in the estoppel doctrine.<sup>153</sup> Perhaps it is better grounded elsewhere. This rule could be appropriately recognized as a central precept of contract law. The insurance company’s breach of the duty to defend is a “material” breach of the insurance policy under section 241 of the Restatement (Second) of Contracts, particularly where that duty is disclaimed.<sup>154</sup> It would entitle the policyholder to a claim for damages for “total breach” under sections 236 and 243 of the Restatement (Second) of Contracts.<sup>155</sup> The policyholder would not be restricted to a claim for partial breach, limited to the duty to defend, because the insurance company has disclaimed *all* of its obligations under the contract, not just

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150. RESTATEMENT OF THE LAW OF LIAB. INS. § 15 (AM. LAW INST., Discussion Draft 2015).

151. *Id.* § 19 cmt. a.

152. *Id.*

153. RESTATEMENT OF THE LAW OF LIAB. INS. § 15 reporters’ note a (AM. LAW INST., Discussion Draft 2015); *accord* Emp’rs Ins. of Wausau v. Ehlco Liquidating Tr., 708 N.E.2d 1122, 1135 (Ill. 1999) (reasoning that once the insurance company breaches its duty to defend, estoppel precludes the insurance company “from raising policy defenses to coverage, even those defenses that may have been successful had” there been no breach); *Ames v. Cont’l Cas. Co.*, 340 S.E.2d 479, 485 (N.C. Ct. App. 1986) (“When an insurer without justification refuses to defend its insured, the insurer is estopped from denying coverage . . .”). *But see* K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co., 6 N.E.3d 1117, 1119 (N.Y. 2014) (reversing prior ruling and rejecting the notion that by having breached a duty to defend, an insurance company is estopped from relying on coverage defenses for purposes of contesting an indemnity obligation).

154. *See* RESTATEMENT (SECOND) OF CONTRACTS § 241 (AM. LAW INST. 1981).

155. *See id.* §§ 236, 243 (AM. LAW INST. 1981).

its defense obligation. The insurance company cannot be heard to assert rights and defenses under the contract it has breached.

This naturally leads to the concept of waiver. If an insurance company has declined to assume the defense, when it had an obligation to do so, it has waived its rights by failing to assume the defense under a timely and proper reservation of rights. Just as a carrier waives its rights by failing to issue a timely and proper reservation of rights in accordance with section 15, a carrier who fails to assume the defense when it is owed should similarly waive all rights to contest coverage. It would clearly be too late for the carrier to assert a reservation of rights upon being held obligated to defend. Those rights would have been waived under section 15. In other words, the decision to disclaim should be viewed as a decision not to reserve rights. As no rights have been reserved, none may be asserted.

An insurance company's breach of the duty to defend is not limited to situations where the carrier disclaims all coverage and refuses to defend. A carrier may also breach its defense obligation by failing to provide an adequate defense or by failing to appoint independent counsel when required. Section 19(1) serves to incentivize a carrier not only to assume the defense, but also to dutifully fulfill its duty to defend.<sup>156</sup>

#### *D. Assignment of Breach of Duty to Defend*

Under section 19(3), the policyholder may "assign to the claimant or to an insurer that takes over the defense all or part of any cause of action for breach of the duty to defend the claim."<sup>157</sup> A small minority of states have been slow to recognize an insurance company's right to contribution

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156. *Twin City Fire Ins. Co. v. City of Madison*, 309 F.3d 901, 906 (5th Cir. 2002) ("The district court concluded that, as a matter of law, estoppel cannot expand coverage in the face of an otherwise applicable policy exclusion. We disagree. When the alleged misconduct of the insurer concerns the duty to defend, the insurer may be liable despite an exclusion otherwise applicable."); *Travelers Cas. & Sur. Co. of Am. v. Neth. Ins. Co.*, 95 A.3d 1031, 1049 n.25 (Conn. 2014) ("If the insurer declines to provide its insured with a defense and is subsequently found to have breached its duty to do so, it bears the consequences of its decision, including the payment of any reasonable settlement agreed to by the plaintiff and the insured, and the costs incurred effectuating the settlement up to the limits of the policy." (quoting *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 67 A.3d 961, 993 (Conn. 2013))).

157. RESTATEMENT OF THE LAW OF LIAB. INS. § 19(3) (AM. LAW INST., Discussion Draft 2015). Similarly, section 27(3) of the Restatement permits assignment of a cause of action or damages arising from breach of the duty to make reasonable settlement decisions. *Id.* § 27(3); accord *Smith v. State Farm Mut. Auto. Ins. Co.*, 7 Cal. Rptr. 2d 131, 135–36 (Ct. App. 1992) (noting that "equalization of the contenders' strategic advantages" through assignment is particularly important where the insurer's bad faith "exposes its policyholder to the sharp thrust of personal liability" (quoting *Critz v. Farmers Ins. Grp.*, 41 Cal. Rptr. 401, 408 (Ct. App. 1964))).

from other insurance companies who are obligated to defend.<sup>158</sup> However, to encourage assumption of the defense, it is important to allow insurance companies that assume the defense to receive contribution from other insurance companies, if that does not harm the policyholder.

Furthermore, assignments of breach of contract and bad faith actions to claimants are an important means of defense for policyholders who are not being provided a defense or whose carriers make unreasonable settlement decisions.<sup>159</sup> When a policyholder is victimized by an insurance company's bad faith, the policyholder often has no financial means of satisfying a judgment other than assigning a claim against the insurance company. Accordingly, an assignment of insurance claims to an injured third party is often the most practical solution.

#### *E. Defense Under Reservation as Breach of Contract*

The Restatement does not address explicitly whether an insurance company's defense under a reservation of rights constitutes a breach of the duty to defend, but it certainly implies that the assumption of the defense under a proper reservation of rights does not constitute a breach. This is an issue that has received considerable treatment in the case law.<sup>160</sup>

Even courts within the same jurisdiction struggle with whether an insurance company's reservation of rights constitutes a "breach" of the duty to defend and what effect a reservation of rights should have over the insurance company's control of the defense. For instance, the Florida District Court of Appeal has held that a policyholder is entitled to reimbursement of independent counsel costs where its insurer offered

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158. Under South Carolina law, "where two companies insure the identical risk and both policies provide for furnishing the [policyholder] with a defense, neither company, absent a contractual relationship, can require contribution from the other for the expenses of the defense where one denies liability and refuses to defend." *Auto-Owners Ins. Co. v. Travelers Cas. & Sur. Co. of Am.*, No. 4:12-cv-3423-RBH, 2014 WL 3687338, at \*7 (D.S.C. July 22, 2014) (quoting *Sloan Constr. Co. v. Cent. Nat'l Ins. Co. of Omaha*, 236 S.E.2d 818, 820 (S.C. 1977)), *aff'd*, 597 F. App'x 197 (4th Cir. 2015). Likewise, under Florida law, "there is no right to contribution between insurance companies as to legal fees and costs." *Am. Cas. Co. of Reading Pa. v. Health Care Indem., Inc.*, 613 F. Supp. 2d 1310, 1322 (M.D. Fla. 2009) (following *Argonaut Insurance Co. v. Maryland Casualty Co.*, 372 So. 2d 960 (Fla. Dist. Ct. App. 1979)).

159. See *Allstate Prop. & Cas. Ins. Co. v. Wolfe*, 105 A.3d 1181, 1185–86 (Pa. 2014). The consensus is that bad faith torts may be assigned. See *Med. Mut. Liab. Ins. Soc'y v. Evans*, 622 A.2d 103, 116–17 (Md. 1993). Section 24 of the Restatement sets forth the liability insurance company's duty to make reasonable settlement decisions, RESTATEMENT OF THE LAW OF LIAB. INS. § 24 (AM. LAW INST., Discussion Draft 2015), while the damages available for the breach of that duty are set forth in section 27. *Id.* § 27.

160. For further discussion, see William C. Carpenter, Note, *Reservation of Rights in Insurance Contracts*, 32 ARIZ. L. REV. 387, 396–402 (1990).

only a defense under a reservation of rights.<sup>161</sup> In reaching its holding, the court reasoned that:

[A] carrier's unilateral defense under a reservation of rights is similar to a refusal to provide any defense at all in its effect on the insured. In either case, the carrier has violated its duties under the policy unconditionally to defend and indemnify its insured within specified limits. The consequence of that violation is that the carrier has transferred to its insured the power to conduct the defense of the claim against its insured.<sup>162</sup>

However, a district court sitting in Florida, in a decision affirmed by the Eleventh Circuit, distinguished between a denial of coverage and a defense provided under a reservation of rights.<sup>163</sup> Specifically, the court held that while both entitle the insured to independent counsel, the latter does not necessarily create a conflict of interest warranting reimbursement of independent counsel defense costs.<sup>164</sup> The court rejected the policyholder's claim for reimbursement of independent counsel defense costs where the insurer had defended under a reservation of rights.<sup>165</sup> The court ruled that the insurer's contractual right to defend "should not be penalized merely because there exists the potential for insurer-selected counsel to become impermissibly conflicted in its representation."<sup>166</sup> "Instead, there must be some evidence to suggest that the conflict between the insurer and the insured actually affected counsel's representation so that it may be said that counsel's actions elevated the interests of the insurer over those of his client, the insured."<sup>167</sup> The court found no evidence of actual conflict, despite that the amended complaint alleged both covered negligence claims and uncovered claims of intentional conduct giving rise to punitive damages.<sup>168</sup>

Instead of treating a defense under a reservation as a breach, the Restatement specifically addresses an insurance company's obligation to provide an independent defense in section 16. Not all reservations of rights entitle the policyholder to an independent defense. Rather, under

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161. *Nationwide Mut. Fire Ins. Co. v. Beville*, 825 So. 2d 999, 1003 (Fla. Dist. Ct. App. 2002).

162. *Id.*

163. *Travelers Indem. Co. of Ill. v. Royal Oak Enters., Inc.*, 344 F. Supp. 2d 1358, 1370 (M.D. Fla. 2004), *aff'd*, 171 F. App'x 831 (11th Cir. 2006).

164. *Id.* at 1375.

165. *Id.*

166. *Id.* at 1374.

167. *Id.*

168. *Id.* at 1362–63, 1374.

section 16, an independent defense must be provided if the defense is undertaken under a reservation of rights *and* “there are common facts at issue in the claim and the coverage defense such that the claim could be defended in a manner that would benefit the insurer at the expense of the insured.”<sup>169</sup>

Importantly, the Restatement defines precisely what an “independent defense” means in section 17. The insurance company loses the “right” to defend the claims,<sup>170</sup> which is defined in section 10 as “[t]he authority to direct all the activities of the defense[,] . . . including the selection and oversight of defense counsel,” as well as “[t]he right to receive from defense counsel all information relevant to the defense or settlement of the claim.”<sup>171</sup> Instead, under section 17, the policyholder has the right to “select defense counsel and related service providers,” such as experts and discovery vendors.<sup>172</sup> The insurance company remains liable to pay the “reasonable” fees of counsel and those “providers on an ongoing basis in a timely manner.”<sup>173</sup>

An insurance company providing an independent defense has a lesser right to receive information, consistent with the right to associate in the defense of the claim as set forth in section 23 of the Restatement. The policyholder’s provision of information to the liability insurance carrier remains confidential. The insurance company and policyholder should still be viewed as being in a “common interest” relationship, despite the partial divergence of interests, sufficient to protect those materials from disclosure to the third party claimant, even though the insurance company cannot compel transmission of confidential communications.<sup>174</sup>

## VI. CONCLUSION

The Restatement does an admirable job of distilling the essential principles of law relating to the duty to defend, especially as it pertains to reservations of rights. In particular, the Restatement lays out clear

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169. RESTATEMENT OF THE LAW OF LIAB. INS. § 16 (AM. LAW INST., Discussion Draft 2015).

170. *Id.* § 17(1).

171. *Id.* § 10.

172. *Id.* § 17(2).

173. *Id.* § 17(3).

174. *See, e.g.,* Lectrolarm Custom Sys., Inc. v. Pelco Sales, Inc., 212 F.R.D. 567, 572 (E.D. Cal. 2002) (holding that while communications between policyholder defended by Cumis counsel and carrier are not per se privileged they are protected from disclosure to third-parties by way of common interest principle); *see also* Douglas R. Richmond, *Independent Counsel in Insurance*, 48 SAN DIEGO L. REV. 857, 893 (2011) (“[T]he attorney-client privilege certainly should extend to independent counsel’s communications with the insurer under the ‘common interest’ doctrine.”).

timing and content requirements for reserving the right to contest coverage. The Restatement also clarifies the remedies for a breach of the duty to defend, as well as establishing a rule of waiver for an insurance company's failure to timely and comprehensively reserve its rights to contest coverage.