

**THE DRAFT ALI RESTATEMENT OF THE LAW OF LIABILITY
INSURANCE: CONSEQUENCES OF BREACH OF THE DUTY TO
DEFEND ARE NOT AND SHOULD NOT BECOME THE
AUTOMATIC FORFEITURE OF COVERAGE DEFENSES**

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I. INTRODUCTION

The American Law Institute's 2014 announcement that the proposed Principles of Liability Insurance would be revised into a Restatement of the Law of Liability Insurance was met with optimism by insurers, who hoped that the new text would offer a comprehensive and even-handed statement of key rules of liability insurance law. However, many insurers view the early proposed drafts of the Restatement, in which every word or phrase will carry a significant meaning, as unnecessarily prejudicial to insurers and in tension with a number of established common law insurance rules. One flashpoint in particular has been the section addressing "Consequences of Breach of the Duty to Defend," in which the Reporters advocate a distinct minority view that an insurer who breaches the duty to defend thereby loses, *inter alia*, the right to contest indemnity coverage for a claim.¹

This section of the draft Restatement, entitled "Consequences of Breach of the Duty to Defend," posits that:

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1. RESTATEMENT OF THE LAW OF LIAB. INS. § 19(1) & cmt. a (AM. LAW INST., Discussion Draft 2015).

(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.

(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.²

At least as proposed at the time of this writing, this section is a major departure from settled insurance law in the majority of states, and the approach taken is not supported by a modern view or emerging trend in the law. Further, there are compelling considerations that weigh against any departure in the Restatement from the longstanding view that a policyholder should be entitled to contract damages, and no more or less, in the event of an insurer's negligent breach of the duty to defend. By denying the insurer the right to contest coverage for the claim, this section would override the insurance agreement terms and automatically award the policyholder full indemnity coverage, up to the policy limits.

This section is, then, a sharp departure from the fundamental concept that an insurance agreement is a contract and that its application is governed by contract law. It rejects the general analysis of the types of damages available for a contractual breach, as set forth in the Restatement (Second) of Contracts.³ Instead, it imposes a dramatic and disproportionate penalty on insurers—the forfeiture of indemnity coverage defenses.

The penalty of forfeiting indemnity defenses is dramatic because it is inconsistent with fundamental insurance concepts such as the fact that the insurance agreements are contracts and the rule that the duty to defend and the duty to indemnify are determined based on different standards. Further, the penalty is disproportionate because the

2. *Id.* § 19 (emphasis added).

3. See RESTATEMENT (SECOND) OF CONTRACTS § 347(a) (AM. LAW INST. 1981) (noting that an injured party's remedy for breach of contract is measured by "the loss in the value to him of the other party's performance caused by its failure or deficiency").

Restatement draft adopts what is essentially a bad faith remedy for an ordinary negligent breach of the duty to defend. It embraces this extreme remedy, moreover, despite the fact that adequate remedies already exist in the event of a negligent breach of the defense duty. And such liability is imposed without regard to the actual contract damages incurred by the policyholder, and is thus heavy-handed and unbalanced.

An automatic forfeiture rule also results in unjust enrichment to the policyholder who receives a windfall of indemnity coverage that was never purchased. Further, it would result in gross violations of public policy by, for example, affording insurance coverage without regard to exclusions for intentional harm. It would also lead to gamesmanship by creating incentives for a policyholder to “set up” an insurer in the hopes of producing some type of breach and thereby obtaining indemnity for an uninsured loss.

The controversy generated by this proposed “automatic forfeiture” rule in the draft Restatement is further fueled by the fact that it would dramatically alter the law of most states without any empirical evidence of the need for a change. There is no evidence that such a penalty is needed to prompt compliance with the insurance contract. Nor are there any studies demonstrating that embracing a minority “automatic indemnity” rule would bring about the result desired by the Reporters, rather than have an undesirable collateral effect and unintended detrimental consequences.⁴ More consideration should be given to the possible consequences of the fundamental change in liability insurance that is being proposed.

The draft Restatement proposes an unprecedented and unbalanced rule. A breach may be negligent, and need not even be material,⁵ to trigger the forfeiture penalty, and the resulting award to the policyholder need not be proportional to the actual damages, if any, it incurred. Through an irrebuttable rule of automatic forfeiture, the current draft Restatement reflects an extraordinary departure from widely followed law regarding the consequences of an ordinary breach of the duty to defend.⁶ It also advocates a minority view in a manner that strips courts of the ability to determine fair outcomes and to moderate or balance

4. The limited authority for an automatic forfeiture rule in a handful of jurisdictions does not provide a basis for broad conclusions about its likely impact on the insurance system if adopted on a wholesale basis throughout the country.

5. As now drafted by the Reporters, the proposed rule concerning “Consequences of Breach of the Duty to Defend” appears to impose a forfeiture of indemnity defenses in response to *any* action found to breach the duty to defend, even a modest mistake as to the reasonable hourly rate to be paid to independent counsel or the share of defense costs owed.

6. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19 reporters’ note a (AM. LAW INST., Discussion Draft 2015) (noting several jurisdictions following the majority view).

legitimate interests. If not amended by the Reporters, the ALI should not approve the proposed rule in the section concerning “Consequences of Breach of the Duty to Defend” and courts should not adopt it.

II. THE PROPOSED RESTATEMENT ADOPTS A DECIDEDLY MINORITY
APPROACH THAT TURNS IMPORTANT LEGAL PRINCIPLES AND POLICY
CONSIDERATIONS ON THEIR HEADS

A. “Automatic” Indemnity is a Minority View

Far from restating or describing the law, the section of the Restatement concerning “Consequences of Breach of the Duty to Defend” adopts a distinct minority view.⁷ Imposing automatic indemnity coverage as the penalty for a negligent breach of the duty to defend is not an incremental or subtle change in the law; it would be a major, startling departure from centuries of settled insurance law in the majority of states.

Under established law in the clear majority of states,⁸ indemnity coverage has never been imposed as an “automatic” penalty for an ordinary breach of the duty to defend.⁹ This case law reflects some of the most fundamental principles of insurance law such as the fact that an insurance agreement is a contract, and its breach is subject to contract damages. Further, the scope and determination of the duty to defend and the duty to indemnify under the insurance policy are very different. Given the wide acceptance of these basic insurance principles, it is not surprising that most authorities nationwide agree that an insurer is not barred from litigating indemnity coverage by virtue of the breach of a duty to defend. This is the law in most jurisdictions across the country,¹⁰ including Alabama,¹¹ California,¹² Colorado,¹³ Florida,¹⁴ Georgia,¹⁵

7. See *id.* § 19 cmt. a.

8. As shown below, in the majority of states, courts have held that a breach of the duty to defend results in contract damages, not automatic forfeiture of indemnity defenses. See *infra* notes 10–34 and accompanying text.

9. See 1 ALLAN D. WINDT, INSURANCE CLAIMS & DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSURED § 4:37 (6th ed. 2013).

10. See *id.* § 4.37 (collecting cases).

11. Ala. Hosp. Ass’n Tr. v. Mut. Assurance Soc’y of Ala., 538 So. 2d 1209, 1216 (Ala. 1989) (holding that “[a] failure of an insurer to defend a claim against an insured does not” bar the insurer from relying on exclusions on the issue of coverage).

12. Hogan v. Midland Nat’l Ins. Co., 476 P.2d 825, 832–33 (Cal. 1970) (in bank) (rejecting the argument that the consequence of a wrongful refusal to defend is that an insurer may not deny coverage).

13. Flannery v. Allstate Ins. Co., 49 F. Supp. 2d 1223, 1229 (D. Colo. 1999) (anticipating that the Colorado Supreme Court would adopt the “majority rule” and holding accordingly

Hawaii,¹⁶ Idaho,¹⁷ Iowa,¹⁸ Kansas,¹⁹ Louisiana,²⁰ Maine,²¹ Maryland,²² Massachusetts,²³ Minnesota,²⁴ Missouri,²⁵ New Hampshire,²⁶ New

that “an insurer is not precluded from contesting coverage when it has breached its obligation to defend its insured, even if such breach was in bad faith”).

14. *McCreary v. Fla. Residential Prop. & Cas. Joint Underwriting Ass’n*, 758 So. 2d 692, 695 (Fla. Dist. Ct. App. 1999) (“[A]n unjustified failure to defend does not require the insurer to pay a settlement where no coverage exists.” (quoting *Ill. Ins. Exch. v. Scottsdale Ins. Co.*, 679 So. 2d 355, 358 (Fla. Dist. Ct. App. 1996))).

15. *Colonial Oil Indus. v. Underwriters Subscribing to Policy Nos. TO31504670 & TO31504671.*, 491 S.E.2d 337, 339 (Ga. 1997) (“[T]he insured is entitled to receive only what it is owed under the contract—the cost of defense. The breach of the duty to defend . . . should not enlarge indemnity coverage beyond the parties’ contract.”).

16. *Sentinel Ins. Co. v. First Ins. Co. of Haw.*, 875 P.2d 894, 912, 914 (Haw. 1994) (adopting “the view of the Supreme Judicial Court of Massachusetts in” *Polaroid Corp. v. Travelers Indemnity Co.*, 610 N.E.2d 912 (Mass. 1993) and explicitly rejecting the approach whereby “a breach of the duty to defend results in an irrebuttable presumption that the insurer is obligated to indemnify its insured”).

17. *Hirst v. St. Paul Fire & Marine Ins. Co.*, 683 P.2d 440, 447 (Idaho Ct. App. 1984) (refusing to adopt the automatic indemnity rule and stating that “[w]e question the propriety of utilizing a form of estoppel as a punitive measure against an insurer for breach of a contractual duty to defend. Rather, we believe the sanctions for that breach should be governed by ordinary principles of contract law”).

18. *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 535 (Iowa 1995) (holding that after breach of the duty to defend and underlying settlement, the party seeking coverage must prove “that (1) the underlying claim was covered by the policy, and (2) the settlement which resulted in the judgment was reasonable and prudent”).

19. *Aselco, Inc. v. Hartford Ins. Grp.*, 21 P.3d 1011, 1020 (Kan. 2001) (refusing to adopt a doctrine creating indemnity coverage as a penalty for the breach of a duty to defend).

20. *Arceneaux v. Amstar Corp.*, 66 So. 3d 438, 452 (La. 2011) (“The duty to defend is provided in the insurance contract; therefore, its breach is determined by ordinary contract law principles and the insurer is liable for the insured’s reasonable defense costs.”).

21. *Elliott v. Hanover Ins. Co.*, 711 A.2d 1310, 1313 (Me. 1998) (declining to compel provision of indemnity coverage in event of defense breach).

22. *Fireman’s Fund Ins. Co. v. Rairigh*, 475 A.2d 509, 516–17 (Md. 1984) (declining to compel provision of indemnity coverage in event of defense breach).

23. *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 921 (Mass. 1993) (reasoning that “there is no reason not to apply normal contract damages principles” to breaches of the duty to defend and ruling that “[a] failure to defend does not bar an insurer from contesting its indemnity obligation” (citing *Ficara v. Belleau*, 117 N.E.2d 287 (Mass. 1954))).

24. *Sellie v. N.D. Ins. Guar. Ass’n*, 494 N.W.2d 151, 156 (N.D. 1992) (finding an insurer that has breached its duty to defend is “still entitled to challenge coverage under the insurance policy” under Minnesota law).

25. *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 193 F.3d 966, 970–71 (8th Cir. 1999) (refusing to apply automatic forfeiture rule because doing so would result in unjust enrichment to policyholder).

26. *A.B.C. Builders, Inc. v. Am. Mut. Ins. Co.*, 661 A.2d 1187, 1191 (N.H. 1995) (“An insurer’s breach . . . should not be used as a method of obtaining coverage for the insured that the insured did not purchase. The relief afforded must bear a reasonable relation to the liability covered and the damages indemnified.” (citations omitted)).

Mexico,²⁷ New York,²⁸ Oregon,²⁹ Pennsylvania,³⁰ Rhode Island,³¹ Texas,³² Virginia,³³ and Washington.³⁴

For instance, following the majority approach, the Massachusetts Supreme Judicial Court addressed the consequences of a breach of the duty to defend in *Polaroid Corp. v. Travelers Indemnity Co.*³⁵ The Massachusetts high court reasoned that “there is no reason not to apply normal contract damages principles” to breaches of the duty to defend and ruled that “[a] failure to defend does not bar an insurer from contesting its indemnity obligation.”³⁶ The court further explained that

[w]e align ourselves with those authorities that treat an insurer’s unjustified refusal to defend as a breach of contract and seek then to determine what is recoverable as contract damages. If an

27. *Servants of Paraclete, Inc. v. Great Am. Ins. Co.*, 857 F. Supp. 822, 835 (D.N.M. 1994) (“[A] breach of the duty to defend cannot create coverage where none actually exists.” (citing *Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford*, 477 N.E.2d 441,444 (N.Y. 1985))).

28. *K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co.*, 6 N.E.3d 1117, 1119–20 (N.Y. 2014) (concluding that an insurer’s breach of the duty to defend does not result in a waiver of defenses to indemnity coverage).

29. *Timberline Equip. Co. v. St. Paul Fire & Marine Ins. Co.*, 576 P.2d 1244, 1248 (Or. 1978) (finding the insurer did not waive the right to rely on policy exclusions because, “[w]hen a contract is breached the injured party is entitled to receive what he would have if there had been no breach; he is not entitled to receive more”).

30. *Am. States Ins. Co. v. State Auto Ins. Co.*, 721 A.2d 56, 64 (Pa. Super. Ct. 1998) (“[W]e will not adopt a blanket rule that if there is a breach of a duty to defend and a settlement, then it automatically requires the breaching insurer to indemnify. . . . The recovery for breaching a duty to defend is to require the breaching insurer to pay for costs of defense.” (citing *Gedeon v. State Farm Mut. Auto. Ins. Co.*, 188 A.2d 320 (Pa. 1963))).

31. *Emhart Indus., Inc. v. Century Indem. Co.*, 559 F.3d 57, 76 (1st Cir. 2009) (“[T]he proper measure of damages for breach of contract is that which the injured party can tie to the breach itself.” (quoting *Emhart Indus., Inc. v. Home Ins. Co.*, 515 F. Supp. 2d 228, 263 (D.R.I. 2007))).

32. *Hartford Cas. Co. v. Cruse*, 938 F.2d 601, 605 (5th Cir. 1991) (holding that the finding of the policyholder’s liability “is distinct from the question of coverage, which cannot be created *ex nihilo* by estoppel” (citing *Hargis v. Md. Am. Gen. Ins. Co.*, 567 S.W.2d 923, 927 (Tex. Civ. App. 1978))).

33. *Capitol Envtl. Servs., Inc. v. N. River Ins. Co.*, 536 F. Supp. 2d 633, 645 (E.D. Va. 2008) (“[E]ven if an insurer breaches the duty to defend, ‘[i]t remains free . . . to argue that the assumed liability was not in actuality covered under its policy, and thus no duty to indemnify arises.’” (alterations in original) (quoting *W. All. Ins. Co. v. N. Ins. Co. of N.Y.*, 176 F.3d 825, 830 (5th Cir. 1999))).

34. *Kirk v. Mt. Airy Ins. Co.*, 951 P.2d 1124, 1126 (Wash. 1998) (en banc) (“The failure to defend without this requisite showing [of an unreasonable, frivolous, or unfounded breach] does not constitute bad faith, trigger a presumption of harm, or allow coverage by estoppel.”).

35. 610 N.E.2d 912 (Mass. 1993).

36. *Id.* at 921 (citing *Ficara v. Belleau*, 117 N.E.2d 287 (Mass. 1954)).

underlying claim . . . is not within the coverage of an insurance policy, an insurer's improper failure to defend that claim would not ordinarily be a cause of any payment that the insured made in settlement of that claim (or to satisfy a judgment based on that claim).³⁷

Similarly, applying Missouri law, in *Esicorp, Inc. v. Liberty Mutual Insurance Co.*, the United States Court of Appeals for the Eighth Circuit held that the proper measure of damages in the event of a breach of the duty to defend is that "reasonably flowing from the breach."³⁸ The policyholder had argued that, because the insurer breached its duty to defend, it should be liable for the full amount of the settlement, regardless of the fact that much of the settlement was related to uncovered claims.³⁹ The court recognized that providing coverage for the uncovered claims in this circumstance would award the policyholder "a windfall in the form of greater insurance coverage than [the policyholder] would have obtained had the insurer defended the underlying case."⁴⁰

The Idaho appellate court also persuasively explained that an insurer should not be estopped from raising coverage defenses as a consequence of breaching its duty to defend. In *Hirst v. St. Paul Fire & Marine Insurance Co.*, the court refused to grant indemnity as a necessary consequence of the insurer's breach of its duty to indemnify:

We decline to adopt the ["automatic" indemnity] rule. We question the propriety of utilizing a form of estoppel as a punitive measure against an insurer for breach of a contractual duty to defend. Rather, we believe the sanctions for that breach should be governed by ordinary principles of contract law. In Idaho, the purpose of awarding damages for breach of contract is to fully recompense the non-breaching party for its losses sustained because of the breach, not to punish the breaching party.⁴¹

As recently as last year, New York's highest court reaffirmed its adherence to the majority view that an insurer's breach of the duty to defend does not result in a waiver of defenses to indemnity coverage.⁴²

37. *Id.*

38. 193 F.3d 966, 970 (8th Cir. 1999).

39. *See id.*

40. *Id.*

41. 683 P.2d 440, 447 (Idaho Ct. App. 1984) (citing *Anderson v. Gailey*, 606 P.2d 90 (Idaho 1980)). The court instead awarded the unpaid defense costs as damages. *Id.*

42. *K2 Inv. Grp. v. Am. Guarantee & Liab. Ins. Co.*, 6 N.E.3d 1117, 1119–20 (N.Y. 2014).

The New York Court of Appeals found “no justification” for departing from settled law on this subject, emphasizing that those advocating forfeiture of indemnity defenses “have not presented any indication that [current law concerning the consequence of an ordinary breach of the duty to defend] has proved unworkable, or caused significant injustice or hardship.”⁴³ The court also recognized the importance of stability and certainty in insurance law, stating that “insurers and insureds alike should ordinarily be entitled to assume that the decision will remain unchanged unless or until the legislature decides otherwise.”⁴⁴

Not only does the rule proposed in the draft Restatement depart from well-established law, the view that the insurer should automatically lose its indemnity coverage defenses is not supported by an emerging trend in the law. Indeed, the handful of decisions adopting this minority view were issued years or even decades ago.⁴⁵ Further, recent state supreme court decisions have cut back on the application of the forfeiture rule in the few jurisdictions that adopted it. For example, although Connecticut adopted an “automatic indemnity” approach in 1967, the Connecticut Supreme Court held in 2013 that the forfeiture of the right to contest coverage would not automatically be applied to create indemnity for the insured’s liability without regard to covered and uncovered portions of a claim.⁴⁶ The draft Restatement’s approach, therefore, is out of step with the current trends in the law, as well as the overwhelming weight of authority.

B. The Automatic Forfeiture of Coverage Defenses Is Inconsistent with Fundamental Insurance Principles

The “automatic” indemnity rule in the draft Restatement is inconsistent with basic insurance concepts—namely that insurance agreements are contracts and that the insurer’s duty to defend and the duty to indemnify are determined based on different standards.

A rule automatically imposing indemnity coverage whenever there has been a breach of the duty to defend cannot be reconciled with

43. *Id.* at 1120.

44. *Id.*

45. See, e.g., *Missionaries of the Co. of Mary v. Aetna Cas. & Sur. Co.*, 230 A.2d 21, 25–26 (Conn. 1967); *Clemmons v. Travelers Ins. Co.*, 430 N.E.2d 1104, 1109 (Ill. 1981); *Applegren v. Milbank Mut. Ins. Co.*, 268 N.W.2d 114, 119 (N.D. 1978).

46. *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 67 A.3d 961, 992 (Conn. 2013) (finding that where the insured settles a dispute involving both covered and uncovered claims following the insurer’s breach of the duty to defend, the insurer is liable only for that part of the settlement that the insured can demonstrate should be apportioned to the claims that triggered the insurer’s duty to defend).

contract law and the damages available for a negligent breach of contract. Under the majority rule, a policyholder is made whole following an insurer's breach of the duty to defend by recovering damages that directly resulted from that breach. Altering these established contract remedies to impose an automatic forfeiture of indemnity coverage defenses is at odds with the general analysis of the types of damages available for a contractual breach, as set forth in the Restatement (Second) of Contracts.⁴⁷

The Reporters suggest that overriding contract law and imposing an automatic forfeiture penalty is necessary to protect the policyholder. In this regard, the Reporters theorize that an insurer might convert its policy from one providing a defense into one simply reimbursing defense costs unless threatened with the penalty of losing its indemnity defenses.⁴⁸ However, in the context of a negligent breach of contract, this makes no sense. An insurer that reasonably but erroneously believes it has no duty to defend by definition is *not* acting with an improper motive to transform its obligations in the parties' insurance agreement.⁴⁹ Also, as discussed *infra*, there are many strong incentives for the insurer to honor a duty to defend. Further, insurance is heavily regulated and, through market conduct examinations and other mechanisms, insurers' conduct is overseen and consumer interests are protected by state insurance commissioners. Simply put, the departure in section 19 from longstanding law that insurance agreements are interpreted as any other contract has not been, and cannot be, justified.

The Restatement's view also diverges from established standards for determining an insurer's obligations with respect to indemnity. It is well settled that an insurer's obligation to indemnify a policyholder is distinct from its obligation to defend. Under prevailing law, the duty to defend is measured against the allegations in the complaint against the insured and assessed based on the claimant's possibility of recovery as a result of an insured loss.⁵⁰ Moreover, the duty to defend may exist even where the

47. RESTATEMENT (SECOND) OF CONTRACTS § 347(a) (AM. LAW INST. 1981) (stating that the injured party's remedy for breach of contract is measured by "the loss in the value to him of the other party's performance caused by its failure or deficiency").

48. RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. a (AM. LAW INST., Discussion Draft 2015).

49. Significantly, the Restatement would impose the loss of indemnity defenses as an automatic penalty for a *negligent* breach of the duty to defend. Section 19 does not limit the forfeiture of defenses to a circumstance where bad faith on the part of the insurer is shown. *See id.* § 19 cmt. g.

50. *See, e.g.,* Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford, 477 N.E.2d 441, 444 (N.Y. 1985).

claims against the insured are “groundless, false or fraudulent.”⁵¹ The duty to indemnify, on the other hand, is separate and narrower.⁵² The duty to indemnify is based on the policyholder’s actual liability to the claimant. A duty to indemnify exists only when a determination is made that a judgment or settlement for which the insured is liable actually falls within the provisions of the policy. Courts nationwide consistently distinguish between the circumstances when there is a duty to defend and a duty to indemnify.⁵³ By automatically tying a duty to indemnify to any situation in which there has been a breach of the duty to defend, the draft Restatement effectively applies the test for a duty to defend to the determination of indemnity coverage. It overrides the fundamentally different standards for determining when there is a duty to defend and a duty to indemnify.⁵⁴ This is a significant and unwarranted change to the insurance mechanism.

C. The Restatement Adopts a Disproportionate and Draconian Remedy for Negligent Breach of the Duty to Defend

The Restatement adopts what might be a bad faith remedy as a consequence for a negligent breach of the duty to defend. A breach of the duty to defend in itself constitutes only a breach of contract. It does not constitute bad faith or violate a covenant of good faith and fair dealing unless it involves unreasonable conduct or is done without proper cause. Yet the “automatic indemnity” rule in the Restatement draft gives no consideration to whether the insurer’s refusal to defend was reasonable.⁵⁵ A reasonable, though erroneous, refusal to defend should lead only to breach of contract damages.⁵⁶ To impose an “automatic indemnity”

51. RESTATEMENT OF THE LAW OF LIAB. INS. § 13 reporters’ note a (AM. LAW INST., Discussion Draft 2015).

52. See *McCreary v. Fla. Residential Prop. & Cas. Joint Underwriting Ass’n*, 758 So. 2d 692, 695 (Fla. Dist. Ct. App. 1999) (quoting *Ill. Ins. Exch. v. Scottsdale Ins. Co.*, 679 So. 2d 355, 358 (Fla. Dist. Ct. App. 1996)).

53. See, e.g., *Atlantic Cas. Ins. Co. v. Value Waterproofing, Inc.*, 918 F. Supp. 2d 243, 261 (S.D.N.Y. 2013).

54. As discussed above, the contractual obligations of defense and indemnity are distinct. It follows, therefore, that the remedies for their breach are similarly distinct and should arise from the breach itself. Where an insurer negligently has breached the duty to defend, the damages should be those that flow from the breach of *that* duty, such as the cost of the defense.

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

56. See *id.* § 19 cmt. f. A draconian remedy, such as that proposed in the draft Restatement, should be based on more than a mistaken judgment. A mere failure to defend does not demonstrate an unreasonable refusal to defend. For example, an insurer might be under the mistaken belief that the party requesting coverage was not an insured, which

penalty for the negligent breach of the duty to defend is an unjustified, punitive approach. Indeed, courts routinely recognize that reasonable mistakes resulting from negligent misconduct should not carry extraordinary, bad faith penalties.

Well-settled law in most states recognizes that there is a difference between merely negligent misconduct on the one hand and bad faith on the other, and that, therefore, different elements of proof are required.⁵⁷ Courts have drawn such a distinction precisely because they want to ensure that the “punishment” fits the crime in each instance. The Restatement’s proposed “automatic” indemnity provision intentionally blurs this line and supports the extreme view that the punishment should be the same without regard to whether an insurer may have merely acted negligently or if it acted unreasonably and in bad faith.⁵⁸ Because existing contract and insurance law already provides adequate remedies in the event of a negligent breach, the proposed Restatement’s punitive approach should be rejected.

Not only does the Restatement approach ignore the degree of “culpability” of the insurer, but there is no consideration given to the relationship between the penalty imposed and the harm actually sustained. The Restatement’s forfeiture rule is not tethered to actual damages resulting from a breach of the duty to defend. It is thus excessive and inordinately punitive to insurers.

Moreover, it results in unjust enrichment and a windfall to policyholders who will receive indemnity coverage that they did not purchase. As Mr. Windt explains, the premise for the majority rule

would be a proper basis for denying coverage. Let us assume, for instance, that an insured has undergone multiple corporate reorganizations and a serious issue exists with respect to whether a particular successor entity is entitled to coverage. If coverage was denied and it later is determined that the entity is an insured, the insurer will have breached its duty to defend. However, there is no basis to conclude that the mistake was unreasonable, or in bad faith. Indeed, the position may have been taken by the insurer in recognition of the importance of preserving coverage limits for an entity known to be insured under the same policy. The consequences should be an award of contract damages actually sustained, not to penalize the insurer (and other insureds) by awarding indemnity coverage for what may actually be an uninsured loss.

57. See, e.g., *Nieto v. Blue Shield of Cal. Life & Health Ins. Co.*, 103 Cal. Rptr. 3d 906, 928 (Cal. Ct. App. 2010) (“[A]n insurer’s bad judgment or negligence is insufficient to establish bad faith . . .” (citing *Chateau Chamberay Homeowners Ass’n v. Associated Int’l Ins. Co.*, 108 Cal. Rptr. 2d 776 (Cal. Ct. App. 2001))); *Commercial Union Ins. Co. v. Liberty Mut. Ins. Co.*, 393 N.W.2d 161, 164 (Mich. 1986) (“[B]ad faith should not be used interchangeably with either ‘negligence’ or ‘fraud.’”); *Brown v. Progressive Ins. Co.*, 860 A.2d 493, 501 (Pa. Super. Ct. 2004) (“[M]ere negligence or bad judgment is not bad faith.” (citing *Adamski v. Allstate Ins. Co.*, 738 A.2d 1033, 1036 (Pa. Super. Ct. 1999))).

58. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. g (AM. LAW INST., Discussion Draft 2015).

against automatic indemnity is that the injured party should not receive more than it would have been entitled to had the contract not been breached:

If an insurer wrongfully refuses to defend an insured, it should be liable for the damages that the insured thereby incurs The insurer's breach of contract should not, however, be used as a method of obtaining coverage for the insured that the insured did not purchase. When a contract is breached, the injured party is entitled to receive what would have been obtained if there had been no breach; the injured party is not entitled to receive more.⁵⁹

That is, the Restatement's proposed rule imposes a disproportionate penalty on the insurer while simultaneously giving an inequitable and unbargained-for advantage to the policyholder. This is undesirable and unfair.⁶⁰

D. Adequate Incentives Already Exist to Enforce Insurers' Defense Obligations

To hold that an insurer forfeits its right to contest indemnity coverage when it has negligently breached its duty to defend would unfairly "punish the insurer for the breach of a contractual duty."⁶¹ It would impose punitive liability where an insurer erroneously denied a defense, without regard for the actual contract damages incurred by a policyholder. The Restatement should not sanction that result. Such indiscriminate "deterrence" is neither necessary nor wise.

Insurers do not approach the duty to defend lightly. In fact, insurance policies commonly provide that there is a *right and* duty to defend in the specified circumstances where coverage attaches. This is because there are important insurer rights that accompany a duty to defend. A

59. WINDT, *supra* note 9, at § 4:37 (footnote omitted); *see also* 1 BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 5.06 (16th ed. 2013).

60. It is also potentially unconstitutional. Imposition of "automatic" indemnity may violate the Due Process Clause of the United States Constitution. Grossly excessive and arbitrary damages, untethered to any underlying contractual liability, raise significant due process concerns. *E.g.*, *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 408, 429 (2003) (striking down \$145 million punitive damage award where plaintiff was entitled to only \$1 million in compensatory damages); *Cooper Indus., Inc. v. Leatherman Tool Grp., Inc.*, 532 U.S. 424, 434 (2001) (quoting *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 562 (1996); *Gore*, 517 U.S. at 562 (citing *TXO Prod. Corp. v. Alliance Res. Corp.*, 509 U.S. 443, 454 (1993) (plurality opinion)).

61. *Sentinel Ins. Co. v. First Ins. Co. of Haw.*, 875 P.2d 894, 912 (Haw. 1994).

defending insurer enjoys rights to select and direct defense counsel, and to determine defense strategy, including whether to settle or to litigate the claim to judgment. Insurers understand that there are consequences of declining to defend and that such consequences can include losing the ability to control the litigation. A negligent breach of the duty to defend may also result in other undesirable consequences for the insurer. For example, some courts hold that an insurer who breaches its duty to defend may be barred from re-litigating in a coverage action issues relating to the policyholder's liability and damages that were determined in the underlying action.⁶² Thus, both the insurance contract terms and existing law provide important and adequate incentives to protect policyholders and deter insurers from disregarding their duty to defend. Adding on an additional penalty of "automatic" indemnity, as proposed in the current draft of the Restatement, is overbroad and unnecessary.⁶³

E. Important Policy Considerations Weigh Against "Automatic Indemnity"

Forcing indemnity coverage any time an insurer breaches the duty to defend would also result in gross violations of public policy. For example, this rule seemingly would afford coverage for a claim without regard to exclusions for intentional or criminal conduct, overriding recognized public policy objections to insurance for intentional torts and criminal acts. Likewise, the rule would negate an insurer's ability to challenge an underlying settlement or judgment for fraud or collusion. Simply put, the Restatement adopts a rule that would result in instances where

62. See, e.g., *Rucaj v. Progressive Ins. Co.*, 797 N.Y.S.2d 79, 82 (App. Div. 2005) ("An insurer, [h]aving disclaimed its duty to defend its insured in the underlying action . . . may not . . . raise defenses extending to the merits of plaintiff's claim against the insured," even where the judgment was rendered by default. The insurer's defenses in such an action are limited to those it would have against the insured . . ." (alterations in original) (citations omitted) (quoting *Robbins v. Mich. Millers Mut. Ins. Co.*, 653 N.Y.S.2d 975, 977 (N.Y. App. Div. 1997))).

63. Courts and commentators have recognized that expanding insurer obligations beyond existing common law rules and contract terms places an unnecessary burden on "ordinary insureds to bear the expense of increased premiums necessitated by the erroneous expansion of their insurers' potential liabilities." *Garvey v. State Farm Fire & Cas. Co.*, 770 P.2d 704, 711 (Cal. 1989) (in bank) (citing *Hartford Fire Ins. Co. v. Superior Court*, 191 Cal. Rptr. 37 (Ct. Appl. 1983)) (noting the destabilizing effects of judicial expansions of coverage on the insurance underwriting process, which relies heavily on contract predictability). There is strong support for the conclusion that enforcing the limits and terms of the policy as written without the creation of new judicial "forfeiture rules" is not only required by the law in most states, but also promotes the proper functioning of the insurance market.

insurance would be afforded in violation of strong public policy concerns. But the Restatement's section on "Consequences of Breach of the Duty to Defend" contains no acknowledgement of these strong public policy exceptions to the proposed "automatic forfeiture" rule.

Public policy interests in the insurance system generally also weigh against the proposed Restatement approach. "Automatic" indemnity must be rejected because it is contrary to the contractual basis of the insurance relationship, which binds the policyholder to the limits and terms of the contract it purchased. Insurers must be able to accurately appraise their exposure, and set premiums based on the limits of their policies. Automatic indemnity interferes with this process, and does so without any demonstrated need for a departure from settled law and established contract remedies—i.e., there is no showing that insurers commonly are abandoning their policyholders and refusing to defend despite the contract terms, or, as the Reporters put it, transforming a duty to defend policy into a duty to reimburse.⁶⁴ Instead, just last year New York's high court found "no justification" for departing from settled law, emphasizing the absence of "any indication that the [current law concerning the consequences of an ordinary breach of the duty to defend] has proved unworkable, or caused significant injustice or hardship."⁶⁵ The forfeiture rule is a particular flash-point in the Restatement draft for insurers because it is so severe and heavy-handed, and because it proposes a dramatic change in the law without necessary justification.

III. AS WRITTEN BY THE RESTATEMENT DRAFTERS, THE FORFEITURE RULE GOES BEYOND ANY POSSIBLE SUPPORT IN THE LAW AND CONTRADICTS BASIC FAIRNESS, COMPELLING POLICY CONSIDERATIONS, AND COMMON SENSE.

Under the current draft of the Restatement, the forfeiture rule is not limited to situations where an insurer unreasonably refuses to undertake

64. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. a (AM. LAW INST., Discussion Draft 2015). If this were taking place, it would presumably be bad faith conduct resulting in severe consequences for the insurer. In addition, as noted, insurers' market conduct is overseen by the state insurance commissioners, who also would address any systematic attempt to alter the obligations provided for in the insurance contract.

65. *K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co.*, 6 N.E.3d 1117, 1120 (N.Y. 2014). The Reporters' treatment of the "Consequences of Breach of the Duty to Defend" in the current draft appears to introduce a subjective element to the analysis of insurance law, simply reflecting what the Reporters advocate as good public policy. And, in addition to the absence of empirical support for the need for a change, it is equally, or even more troubling, that there is no evidence that the new proposed rule would accomplish its desired result rather than have unintended, detrimental consequences.

the defense, or materially breaches its duty to defend resulting in substantial harm to the policyholder.⁶⁶ The proposed rule regarding forfeiture of indemnity coverage defenses applies to *any* breach of the duty to defend, even a modest, reasonable mistake as to—for example—the market-hourly rate to be paid to independent counsel, or the pro rata share of defense costs owed by an individual insurer sharing the costs of defense with others.⁶⁷ This would go far beyond even the discredited minority cases that have imposed automatic indemnity coverage for an insurer’s breach of the duty to defend.

Moreover, the Restatement imposes the broadest possible interpretation of defense obligations, often adopting minority or even unsupported positions on the scope and extent of the duty to defend.⁶⁸ By both reaching beyond widely accepted limits on the duty to defend and imposing a draconian bad faith remedy for any negligent breach of that duty, the Restatement advocates a rule that would be breathtaking in its scope and impact. This expansion of the duty to defend together with the forfeiture of indemnity defenses in response to *any* breach of the expanded defense duty introduces an unwelcome, objectionable “tilt” into the law of liability insurance.

A. *The Restatement’s Forfeiture Rule Creates Adverse Incentives*

The “automatic” indemnity rule would open the door to gamesmanship. It would incentivize the policyholder to attempt to obtain free indemnity coverage by manufacturing a dispute with respect to the insurer’s conduct in meeting its defense obligation. Many cases document that some policyholders do overreach in contending that the defense

66. RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. b (AM. LAW INST., Discussion Draft 2015). By not limiting the Restatement’s proposed forfeiture rule to the circumstance of a material breach with serious adverse consequences to the policyholder, the Reporters’ current draft goes too far. It truly opens the door not just to a punitive and minority view, but also to the expansion of obligations untethered to any notion of proportionality.

67. *Id.* The Comment states that “[a]ctions that breach the duty to defend include a failure to defend when required, a provision of an inadequate defense, a failure to provide an independent defense when required, and a withdrawal of a defense when the duty to defend has not terminated.” *Id.* Each of these aspects of the defense obligation involves difficult, unsettled questions of law, although the draft Restatement seems to imply they are simple, straightforward actions that would be violations of black letter law governing the duty to defend.

68. The draft Restatement vastly expands the insurer’s defense-related obligations through its positions on these defense-related obligations in the Comments and Reporters’ Notes, as well as in other sections. For instance, the Restatement limits when an insurer can properly withdraw from the defense by requiring in most instances a “[f]inal adjudication that the insurer does not have a duty to defend.” *Id.* § 18(8).

provided by an insurer was somehow deficient.⁶⁹ The Restatement rule would encourage this type of over-reaching by the policyholder, and would tip the scale by creating strong disincentives for insurers to resist such efforts. An insurer would be reluctant to refuse to pay any claimed defense amount, because—if it guessed wrong—the insurer could then also be forced to indemnify an uninsured judgment or settlement. In another example, a policyholder might attempt to secure free indemnity coverage for a case where most of a claim was plainly uncovered by disputing the rate to be paid to independent counsel. A policyholder made precisely such an attempt, for instance, in *Santa's Best Craft, L.L.C. v. Zurich American Insurance Co.*, where the court rejected the insured's argument that the insurer breached the duty to defend by only paying those costs incurred by insured's defense counsel that were deemed reasonable and necessary to the defense.⁷⁰ Again, the Restatement creates an incentive for the policyholder to insist on an unreasonably high rate because if the insurer is found to have wrongfully disputed the fees, the policyholder could be rewarded with "free" indemnity coverage. The current Restatement approach would thus sanction absurd results.⁷¹

69. See, e.g., *Mount Vernon Fire Ins. Co. v. VisionAid, Inc.*, 91 F. Supp. 3d 66, 69–70 (D. Mass. 2015) (addressing policyholder's argument that an insurer's refusal to fund the policyholder's affirmative counterclaim was a breach of the duty to defend); *Petro v. Travelers Cas. & Sur. Co. of Am.*, 54 F. Supp. 3d 1295, 1307 (N.D. Fla. 2014) (rejecting insured's argument that insurer provided inadequate defense, and thus breached its duty to defend); *Park Townsend, LLC v. Clarendon Am. Ins. Co.*, 916 F. Supp. 2d 1045, 1049–50 (N.D. Cal. 2013) (finding that insured failed to state a claim for breach of the duty to defend based on insurer's failure to pay for independent counsel where insured's complaint did not support conclusion that insurer's reservation of rights and conduct of insurer's counsel created a conflict of interest).

70. 941 N.E.2d 291, 300 (Ill. App. Ct. 2010). The Restatement does not fully take into account the fact that disputes over the conduct of the defense, especially with respect to rights to independent counsel, can take many forms. Compare *N.Y. State Urban Dev. Corp. v. VSL Corp.*, 738 F.2d 61, 65–66 (2d Cir. 1984) (addressing dispute over whether insurer has the right to choose insured's independent counsel under New York law), with *Aquino v. State Farm Ins. Cos.*, 793 A.2d 824, 832 (N.J. Super. Ct. App. Div. 2002) (addressing dispute over whether insurer can require certain rates for independent counsel), and *Coats, Rose, Yale, Ryman & Lee, P.C. v. Navigators Specialty Ins. Co.*, 830 F. Supp. 2d 216, 220–21 (N.D. Tex. 2011) (addressing whether insured has right to independent counsel), *aff'd*, 489 F. App'x 769 (5th Cir. 2012).

71. The Reporters weakly respond to the fact "that the forfeiture-of-coverage-defense rule harms insureds as a group by requiring insurers to pay claims that are not covered, thereby unjustly enriching [individual] insureds that prevail in an action for breach of the duty to defend." RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. a (AM. LAW INST., Discussion Draft 2015). The Reporters contend that an insurer may preserve its coverage defenses and refuse to pay a claim, as long as it provides a defense subject to a reservation of rights and then, if appropriate, institutes a declaratory-judgment action to terminate the duty to defend. *Id.* However, section 19 so heavily penalizes the insurer that reasonably but erroneously fails to defend, that the insurer essentially must defend in order to preserve its

B. The Restatement's Forfeiture Rule Imposes a Harsh Remedy Independent of the Facts of the Insurer's Breach and Any Harm It May Cause

The concerns presented by the Restatement rule are deepened because the forfeiture rule is imposed without any materiality test relating to the nature of the breach, without any showing of unreasonable conduct by the insurer, and without any relationship between alleged harm and the remedy. As noted, a minor mistake by an insurer—such as misjudging the market rate for attorneys' fees while consistently paying for and conducting the defense—could conceivably result in the complete forfeiture of all indemnity defenses. There is also no proportionality test for the remedy of forfeiture of indemnity defenses. Thus, the severity of an insurer's breach and the extent of any harm to the policyholder are not tied to a particular result; instead, every breach of the duty to defend carries the same extreme consequences.

Notably, an insurer found to have breached the duty to defend has no opportunity to demonstrate why application of the forfeiture rule is or may be inappropriate in the particular situation presented. A court could not even consider the compelling individual factors weighing against the rule's application. The rule would be applied for a negligent breach of a modest nature, resulting in a gross windfall to the policyholder in violation of established public policy.⁷²

It is an important objective to reach fair outcomes. There are no limitations on the proposed Restatement rule or opportunities to consider

right to contest indemnity. *See id.* § 19(2). Keep in mind that, under the Restatement's approach, the insurer that provides a defense subject to a reservation of rights usually must obtain a court order to terminate the defense, *id.* § 18 cmt. a, and cannot recoup uncovered defense costs it advances. *Id.* § 21. The combined effect of these lopsided provisions—applied in the event of mere negligence—would essentially be to force the insurer to pay uncovered defense costs in order to avoid being forced to pay uncovered indemnity amounts.

72. Not only would this result in disproportionate awards, it also could result in double recovery, where a policyholder would recover in excess of actual damages or amounts it owed for a judgment or settlement. Consider, for instance, the situation where a policyholder has settled with one or more insurers and recovered a portion of a settlement or judgment, but successfully pursues another insurer that denied coverage. If the policyholder establishes a negligent denial of the duty to defend, surely the remaining insurer should not lose the right to contest damages in the amount of a judgment entered against the insured or to obtain an offset to account for the prior settlements. If the insurer lost such rights, as the Restatement suggests, the policyholder could then obtain the full amount of a judgment or settlement from the remaining insurer, resulting in double recovery. The Restatement draft does not explicitly limit any policyholder recovery to an amount that would make the policyholder whole. Of course, well-settled contract damages principles do so, and should not be displaced by a deeply flawed "automatic indemnity" approach.

the facts of the case as a whole.⁷³ Fairness—and the potential negative impact of awarding an undeserving party and penalizing a party that made an honest mistake—is not taken into account. As written, the Restatement approach makes no effort to be temperate or moderated; instead, a draconian, heavy-handed outcome is mandated by the proposed black letter rule. Even if the predicate for supporting a change in the law were evident (which it is not), this would not be a wise or appropriate way to introduce into the jurisprudence what is a drastic departure from settled law and practice in the vast majority of states.

IV. CONCLUSION

In addressing the “Consequences of Breach of the Duty to Defend,” the draft Restatement of the Law of Liability Insurance goes far beyond an orderly statement of the common law, or even the advocacy of minority positions found in the common law. By expanding coverage beyond settled law, and even beyond minority positions in the common law, the proposed draft does not provide clarity in the law. Rather, the Restatement draft as it stands interferes with the certainty provided by the existing common law with respect to the defense obligation and the consequences of its breach. Section 19 distorts the insurance relationship where there has been no showing of a need to do so, and such dramatic changes to existing authority and insurance practice in the vast majority of jurisdictions would surely have unintended, and unfortunate consequences.

73. The Restatement rule does not just introduce the forfeiture of indemnity defenses as a possible remedy for cases where it is deemed appropriate, but mandates that outcome. The court is not allowed to balance the applicable considerations reflecting the legitimate interests of both parties, and to determine the appropriate damages under the facts and circumstances.