

**DOES THE DRAFT RESTATEMENT OF THE LAW OF LIABILITY  
INSURANCE WRONGLY ELEVATE PROOF AND OVERVALUE  
LEGAL UNCERTAINTY? YES, GIVEN THE FORESEEABLE RISK  
INSURERS MAY MORE OFTEN DECLINE THE DUTY TO  
DEFEND AS A RESULT**

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*This Commentary focuses on the proposed Restatement of the  
Law of Liability Insurance 2016, Tentative Draft No. 1,  
sections 4, 13, 18, 19, 21, and associated materials.*

Tentative Draft No. 1 of the American Law Institute’s forthcoming Restatement of the Law of Liability Insurance<sup>1</sup> is admirable in many important respects. However, proposed section 13 can be falsified in too many instances to serve as a meaningful statement of black letter law governing an insurer’s duty to defend.<sup>2</sup> This Commentary will consider how proposed section 13 and associated provisions of the proposed Restatement might influence the decision by insurers to defend their insureds, particularly in instances of so-called “legal uncertainty.”

Proposed section 13 directs a liability insurer to determine its duty to defend an insured by combing through the allegations by a complainant against its insured to determine whether a “legal action,” is based in whole or in part on allegations which, if “proven,” might be

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1. At its 2016 Annual Meeting, the reporters presented, and the membership of the American Law Institute (ALI) approved §§ 1–36 and 38–43 of Tentative Draft No. 1 of the new Restatement of the Law of Liability Insurance, subject to discussion and usual editorial prerogative. See <https://www.ali.org/projects/show/liability-insurance/>. Unless otherwise stated, all black letter law, comments, and illustrations referenced below are from the Restatement of the Law Liability Insurance, Tentative Draft No. 1 (April 11, 2016), copyright © 2016, by The American Law Institute. Reproduced with permission. All rights reserved. The pertinent text of all such referenced sections is included in the Appendix hereto. The ALI states: “As of the date of publication, this Draft had not been considered by the members of The American Law Institute and therefore did not represent the position of the Institute on any of the issues with which it deals. The action, if any, taken by the members with respect to this Draft may be ascertained by consulting the Annual Proceedings of the Institute, which are published following each Annual Meeting, and are available for purchase through the Institute website at [www.ali.org](http://www.ali.org).”

2. RESTATEMENT OF THE LAW OF LIAB. INS. § 13 (AM. LAW INST., Tentative Draft No. 1, 2016).

“covered” by its policy (even if those “allegations” are without merit).<sup>3</sup> As the illustrations that follow this proposed black letter rule demonstrate quite clearly, the proffered rule conflates the potential proof of alleged facts and putative insurance coverage of “legal theories” and thus misapprehends the bases for “coverage” under a standard liability insurance policy.

The illustrations used to support the proposed rule reveal these deficiencies. To wit, illustration 1 underscores the difficulties associated with applying it.<sup>4</sup> Illustration 1 sets forth in basic form a fact pattern considered in a seminal opinion by the California Supreme Court involving a claim against an insured for assault.<sup>5</sup> The drafters suggest that the duty to defend was found in that case to have been triggered based on the potential viability of the insured’s version of the events.<sup>6</sup>

To the contrary, the California Supreme Court repeatedly emphasized that the pleaded characterizations of the events at issue were nearly irrelevant to its opinion about whether a duty to defend was triggered with respect to the alleged harm upon which a damage claim against the insured was based.<sup>7</sup> In particular, the duty to defend did not arise because the insured’s claim to have acted in self-defense, perhaps “negligently,” might have been proven true.<sup>8</sup> Rather, the duty to defend arose because the suit sought from the insured damages because of bodily injury and because the plaintiff’s allegations

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3. *Id.* § 13(a).

4. *See id.* § 13 cmt. b, illus. 1 (presenting a classic fact pattern arising out of an incident of road rage).

5. *See id.* § 13 reporters’ note b (“Illustration 1 is based on *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966).”).

6. *See id.* § 13 cmt. b, illus. 1 (“On these facts, the plaintiff has the potential to recover from the insured on a negligent self-defense theory that would be covered.”).

7. *See Gray*, 419 P.2d at 176–77 (“Since modern procedural rules focus on the facts of a case rather than the theory of recovery in the complaint, the duty to defend should be fixed by the facts which the insurer learns from the complaint, the insured, or other sources. An insurer, therefore, bears a duty to defend its insured whenever it ascertains facts which give rise to the potential of liability under the policy.”).

8. *Compare id.* at 174–75 (“The very first paragraph as to coverage . . . provides that ‘the company shall defend any such suit against the insured alleging such bodily injury’ although the allegations of the suit are groundless, false or fraudulent. This language, in its broad sweep, would lead the insured reasonably to expect defense of [a]ny suit [seeking damages because of bodily injury] regardless of merit or cause. . . . We look to the nature and kind of risk covered by the policy as a limitation upon the duty [to] defend; we cannot absolve the carrier from the duty to defend an insured for loss of the nature and kind against which it insured.”), with KENNETH S. ABRAHAM & DANIEL SCHWARTZ, *INSURANCE LAW AND REGULATION: CASES AND MATERIALS* 584 (6th ed. 2015) (“It is very well established, both as a matter of insurance policy interpretation and legal doctrine, that the insurer must defend any suit whose allegations would fall within coverage if the allegations were *proved to be true.*” (emphasis added) (citing *RESTATEMENT OF THE LAW OF LIAB. INS.* § 15 (AM. LAW INST., Discussion Draft 2015))).

(including the allegation that the insured acted intentionally) might not have been proven or were, in the relevant context, irrelevant.<sup>9</sup>

In general, the truth or falsity of the allegations of a complaint against an insured almost always will be irrelevant in determining whether an insurer's duty to defend is triggered. Any reference in the proposed rule to hypothetical "proof" of the "allegations" in a complaint against an insured is thus misplaced and misleading. The duty to defend arises if an insurer knows or should know at the time of tender that its duty to indemnify an insured might arise. This determination is not made by reference to the potential that the pleaded transactional facts alleged by a complaint (or in defense) might be proven, but instead turns on the nature of the risk insured and the injury alleged.<sup>10</sup>

Just like hypothetical "proof" of alleged facts, the "legal theories" claimed to justify recovery from the insured on the alleged facts almost always will be irrelevant to assessing an insurer's duty to defend its insured. The comments to proposed section 13 concerning an insurer's duty to defend appear to misstate this principle by reason of repeated reference to "covered legal theories."<sup>11</sup>

For example, the comments with respect to the first illustration demonstrating the application of proposed section 13 state: "On these facts, the plaintiff ha[d] the potential to recover from the insured on a negligent self-defense theory that would be covered."<sup>12</sup>

Leaving aside the fact that the California Supreme Court has dispelled any notion that a "negligent self-defense theory" might convert an intentional striking—even in self-defense—into a striking done without such intent, i.e., an "unintentional" act,<sup>13</sup> and leaving

9. See *Gray*, 419 P.2d at 177 ("[The] complaint clearly presented the possibility that [the plaintiff] might obtain damages that were covered by the indemnity provisions of the policy. Even conduct that is traditionally classified as 'intentional' or 'wilful' has been held to fall within indemnification coverage.").

10. See, e.g., *Vandenberg v. Superior Court*, 982 P.2d 229, 245 (Cal. 1999) ("[C]ourts must focus on the nature of the risk and the injury, in light of the policy provisions, to make [a] determination [concerning an insurer's duty to defend its insured.]"); see also *supra* note 8.

11. RESTATEMENT OF THE LAW OF LIAB. INS. § 13 (AM. LAW INST., Tentative Draft No. 1, 2016).

12. *Id.* § 13 cmt. b, illus. 1.

13. See *Delgado v. Interinsurance Exch. of the Auto. Club of S. Cal.*, 211 P.3d 1083, 1090 (Cal. 2009) ("[*Gray v. Zurich Insurance Co.*] stated that an unreasonable belief in the need for self-defense could remove the resulting act from the reach of the policy's exclusion clause for intentional acts (that is, makes the act 'nonintentional'). *Gray* did not say, however, that such a belief would convert an intentional act into an unintentional act . . . . Acceptance of [this] argument would render *Gray's* statement nonsensical, because a purposeful and intentional act remains purposeful and intentional regardless of the reason or motivation for the act." (first citing *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 177 (Cal. 1966) (in bank); then citing *Hogan v. Midland Nat'l Ins. Co.*, 476 P.2d 825,

aside the fact that it is awkward to say that the claimant might have recovered on the *defendant's* theory of the case, the insured's "legal theory" was never determinative or even particularly relevant to assessing the insurer's duty to defend on the facts presented in illustration 1.<sup>14</sup> Yet, based on the comments pertinent to this illustration, one begins to suspect that proposed section 13 reflects a misapprehension that certain "legal theories" are "covered" and certain "legal theories" are not.<sup>15</sup>

This suspicion is confirmed by the second illustration demonstrating the application of proposed section 13. Reference to the putative relevance of the "legal theories" described in illustration 2<sup>16</sup> underscores the notion that the proposed Restatement does not accidentally elevate to determinative importance the supposed relevance of the insured's defense theory in illustration 1.

In illustration 2, the proposed Restatement appears to double down on the notion that the "legal theory" asserted by a claimant or by the insured may control whether a duty to defend arises. In this illustration, the insured is sued for bodily injury sustained during a fight in a bar. The complaint contains two counts. In the first count, the plaintiff alleges that the insured intentionally struck the plaintiff. In the second count, the plaintiff alleges that the insured negligently struck the plaintiff. The proposed Restatement instructs: "[In this illustration] the insurer has a duty to defend because count two in the complaint sets forth a *covered legal theory*."<sup>17</sup> One marvels.

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828–29 (Cal. 1970) (in bank); then citing *Lyons v. Fire Ins. Exch.*, 74 Cal. Rptr. 3d 649, 656 (Ct. App. 2008); and then citing *Swain v. Cal. Cas. Ins. Co.*, 120 Cal. Rptr. 2d 808, 813–14 (Ct. App. 2002)). In *Delgado*, the California Supreme Court concluded, "an insured's unreasonable belief in the need for self-defense does not turn the resulting purposeful and intentional act of assault and battery into 'an accident' within the policy's coverage clause. Therefore, the insurance company had no duty to defend its insured in the lawsuit brought against him by the injured party." 211 P.3d at 1092.

14. *See id.*; *see also Gray*, 419 P.2d at 176 ("[C]ourts do not examine only the pleaded word but the potential liability created by the suit.")

15. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 13 cmt. b, illus. 1 (AM. LAW INST., Tentative Draft No. 1, 2016) (suggesting that the duty to defend was triggered because an affirmative defense created a "covered legal theory"). To the contrary, some authorities believe *Gray* turned on speculation about *unasserted claims*. *See, e.g., James M. Fischer, Broadening the Insurer's Duty to Defend: How Gray v. Zurich Insurance Co. Transformed Liability Insurance into Litigation Insurance*, 25 U.C. DAVIS L. REV. 141, 159–60 (1991) ("The issue was not whether *asserted* claims stated a claim potentially within coverage. Rather, the contractual duty to defend was triggered by *unasserted* claims. . . . In other words, the duty was based on speculation about the future rather than the realities of the present." (footnote omitted)).

16. RESTATEMENT OF THE LAW OF LIAB. INS. § 13 cmt. b, illus. 2 (AM. LAW INST., Tentative Draft No. 1, 2016).

17. *Id.* (emphasis added).

The standard liability insurance policy does not “cover legal theories.” The standard liability insurance policy provides that the insurer will pay on behalf of the insured sums the insured may be held legally liable to pay as a consequence of “bodily injury,” “property damage,” or some other type of harm, and further provides that the insurer will defend the insured against claims or suits seeking to recover damages for such harm.<sup>18</sup> The legal theory asserted by the injured party (or by the insured in defense) is irrelevant to a coverage analysis—reference to “covered legal theories” is thus conceptually wrong and seriously misstates the proper approach.<sup>19</sup>

This point can be simply illustrated by a complaint which alleges that the insured breached a contract to perform in a “workmanlike manner.” The pleader’s legal theory—breach of contract—will be irrelevant to whether the insurer has a duty to defend its insured. The authorities are legion holding that this sort of “breach of contract” claim may trigger the duty to defend.<sup>20</sup> On the other hand, a claim sounding in “negligence” does not necessarily trigger an insurer’s duty to defend its insured.<sup>21</sup>

Certain provisions of the proposed Restatement that suggest an

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18. See, e.g., ABRAHAM & SCHWARTZ, *supra* note 8, at 439 (demonstrating that a specimen commercial general liability (CGL) policy provides: “We will pay those sums that the insured becomes legally obligated to pay as damages because of ‘bodily injury’ or ‘property damage’ to which this insurance applies. We will have the right and duty to defend the insured against any ‘suit’ seeking those damages.”).

19. See, e.g., *Vandenberg v. Superior Court*, 982 P.2d 229, 245 (Cal. 1999). In *Vandenberg*, the court held that the construction of a liability insurance policy insuring agreement which required the insurer to indemnify the insured for any sums the insured was “legally obligated to pay as damages” did not require distinguishing contract from tort theories of recovery. *Id.* The court stated: “Predicating coverage upon an injured party’s choice of remedy or the form of action sought is not the law . . . . Instead, courts must focus on the nature of the risk and the injury, in light of the policy provisions, to make that determination.” *Id.* (citing *AIU Ins. Co. v. Superior Court*, 799 P.2d 1253 (Cal. 1990) (in bank)). The court thereupon concluded: “[The] insurers cannot avoid coverage for damages awarded against [the insured] . . . solely on grounds the damages were assessed on a contractual theory.” *Id.* at 246.

20. See, e.g., *id.*

21. See, e.g., *Markel Am. Ins. Co. v. Staples*, No. 3:09-CV-435-HEH, 2010 WL 370304, at \*5, \*6 (E.D. Va. Jan. 28, 2010) (granting summary judgment for insurers, finding no duty to defend or indemnify and stating, based on collected authorities: “[T]he most persuasive authority leads to the conclusion that the mere presence of a negligence claim is insufficient to [trigger the insurer’s duties]. Instead, a reviewing court should examine the facts of the underlying complaint and the nature of the claim.”); see also *Swain v. Cal. Cas. Ins. Co.*, 120 Cal. Rptr. 2d 808, 812–13 (Ct. App. 2002) (“A general boilerplate pleading of ‘negligence’ adds nothing to a complaint otherwise devoid of *facts* giving rise to a potential for covered liability[.] . . . [t]he pleading of alternative legal theories of liability does not alter the nature of the conduct which forms the basis for the complaint.” (alteration in original) (quoting *Michaelian v. State Comp. Ins. Fund*, 58 Cal. Rptr. 2d 133, 142 (Ct. App. 1996))).

insurer's duty to defend arises with respect to "covered legal theories" thus encourage a problematic misapprehension of long-standing precepts of insurance law that eschew any comparable approach.

The more deeply one explores these deficiencies in proposed section 13, and the illustrations which follow it, the more clearly one sees how these deficiencies may influence the answers to more complex coverage questions. For example, the drafters of the proposed Restatement have affirmed a widely-accepted distinction between *factual* and *legal* uncertainty with respect to an insurer's duty to defend.<sup>22</sup> The Comments to proposed section 21 validate putative bases for an insurer's claim that its duty to defend an insured is negated, *nunc pro tunc*, if a legal uncertainty concerning the insurer's potential duty to indemnify its insured is ultimately resolved in its favor.<sup>23</sup>

As explained by the proposed Restatement, most authorities agree that an insurer's duty to defend arises as a result of a *factual* uncertainty concerning its ultimate duty to indemnify its insured, as in illustration 1 to section 13.<sup>24</sup> In these instances, the insurer may not recoup advanced defense costs, even if the insurer properly reserved its rights to do so and even if the insurer ultimately establishes that the insurer never had even an immature duty to indemnify its insured.<sup>25</sup>

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22. See RESTATEMENT OF THE LAW OF LIAB. INS. § 13 cmt. f (AM. LAW INST., Discussion Draft, 2015) ("In some cases, coverage for a claim may be uncertain because of legal uncertainty. For example, the courts of the relevant jurisdiction may not have yet determined the meaning of an insurance policy term or there may be uncertainty regarding the application of the policy term to the facts as alleged in the complaint. In determining whether to undertake the defense of an insured, an insurer is not required to resolve legal uncertainty in favor of the duty to defend, though it may be prudent for the insurer to do so."); see also RESTATEMENT OF THE LAW OF LIAB. INS. § 21 cmt. a (AM. LAW INST., Tentative Draft No. 1, 2016 (explaining the effect that a distinction between legal and factual uncertainty may have on an insurer's duty to defend its insured)).

23. See RESTATEMENT OF THE LAW OF LIAB. INS. § 21 cmt. a (AM. LAW INST., Tentative Draft No. 1, 2016) ("If an insurer provides a defense under a reservation of rights, and the coverage dispute is subsequently decided in the insurer's favor, the insurer may have provided a defense of claims that were *outside the scope of its duty to defend, measured by the rule of § 13*. Any time an insurer is defending under a reservation of rights because of a *factual* uncertainty related to a coverage defense, the insurer has a contractual duty to defend until that duty is terminated in the manner specified in § 18 of this Restatement, and, thus, the defense of the claim is within the scope of the duty to defend. When an insurer is defending because of *legal* uncertainty regarding its duty to defend, however, a court may later determine that the insurer did not have the duty to defend; in such a case, the insurer will have incurred costs *that it was not legally obligated to incur*. . . . Although existing insurance policies generally do not grant insurers a right to recoupment, a slim majority of the courts that have considered this issue have held that insurers are nevertheless entitled to recover the costs of defending [such] uncovered actions on a theory of unjust enrichment." (emphasis added)).

24. See *id.* § 13 cmt. b, illus. 1.

25. See *supra* note 23.

After all, “the duty to defend is broader than the duty to indemnify.”<sup>26</sup>

However, in the instance of a *legal* uncertainty (i.e., the uncertain construction of a term of an insurance contract as applied to the facts), a slim majority of (but not all) courts have permitted an insurer, pursuant to a theory of “unjust enrichment,” to recoup defense costs advanced pursuant to a reservation of the right to so recoup, provided that the “legal uncertainty” concerning the insurer’s duty to indemnify its insured is ultimately resolved in the insurer’s favor.<sup>27</sup> In these instances, so the theory goes, the insurer’s duty to defend *never arose*.<sup>28</sup>

This distinction is established by some authorities; however, in the view of others, purported distinctions based on a supposedly dispositive dissimilarity between factual and legal uncertainty with respect to an insurer’s duty to defend are contrary to better reasoned analyses.<sup>29</sup>

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26. See, e.g., *Certain Underwriters at Lloyd’s of London v. Superior Court*, 16 P.3d 94, 102, 103 (Cal. 2001) (“Whereas the duty to indemnify may indeed be broad, the duty to defend must perforce be broader still.” (citing *Aerojet-Gen. Corp. v. Transp. Indem. Co.*, 948 P.2d 909, 921 (Cal. 1997); *Buss v. Superior Court*, 939 P.2d 766, 773 (Cal. 1997)); see also *Auto. Ins. Co. of Hartford v. Cook*, 850 N.E.2d 1152, 1155 (N.Y. 2006) (“It is well settled that an insurance company’s duty to defend is broader than its duty to indemnify. Indeed, the duty to defend is ‘exceedingly broad’ and an insurer will be called upon to provide a defense whenever the allegations of the complaint ‘suggest . . . a reasonable possibility of coverage.’” (alteration in original) (citation omitted) (quoting *Cont’l Cas. Co. v. Rapid-Am. Corp.*, 609 N.E.2d 506, 509 (N.Y. 1993))).

27. See *supra* note 23.

28. *Id.*

29. See, e.g., *Hugo Boss Fashions, Inc. v. Fed. Ins. Co.*, 252 F.3d 608, 622 (2d Cir. 2001); *Soto v. Country Mut. Ins. Co.*, No. 2-14-1166, 2015 WL 5307297, at \*10 (Ill. App. Ct. Sept. 9, 2015). In *Hugo Boss Fashions, Inc. v. Federal Insurance Co.*, an insurer was obligated to defend, but not indemnify, its insured where there was “*legal* uncertainty as to insurance coverage” because “the New York cases establish that [s]o long as the claims [asserted against the insured] may rationally be said to fall within policy coverage, *whatever may later prove to be the limits of the insurer’s responsibility to pay*, there is no doubt that it is obligated to defend.’ In other words, a separate, contractual duty to defend exists, and perdures until it is determined *with certainty* that the policy does not provide coverage.” 252 F.3d at 620, 622 (alteration in original) (citation omitted) (quoting *Seaboard Sur. Co. v. Gillette Co.*, 476 N.E.2d 272, 275 (N.Y. 1984)). In *Soto v. Country Mutual Insurance Co.*, an insurer was estopped from asserting policy defenses, even those that might have been successful, and was held liable for a judgment against its insured based on failure to defend. 2015 WL 5307297, at \*10–11. The court explained the issue as follows: “At risk of beating a dead horse, we note that we are not determining the ultimate question of coverage. Instead, we are asked to consider whether, when the complaint was presented, there was *clearly* no *potential* for coverage under the liability policy. . . . [W]hile it very well might be that the policy does *not*, ultimately, cover the claim, the threshold for the complaint to present a claim of *potential* coverage is low. There exist sufficient bases here to find unclear the existence of potential coverage.” *Id.* at \*8. The court thereupon held: “[The insurer]’s position requires the reconciliation and cross-referencing of several seemingly contradictory provisions. In our view, if a coverage dispute cannot be resolved short of interpretation akin to that which would occur in a declaratory judgment action, the matter likely reflects *potential* coverage such that an

If a “legal uncertainty safe harbor,” is recognized as retroactively excusing *ab initio* an insurer’s declination of its uncertain duty to defend its insured (i.e., prior to a final adjudication eliminating the uncertainty or some other recognized determination of the insurer’s potential indemnity obligation),<sup>30</sup> then the duty to defend and the duty to indemnify are rendered “co-extensive.”<sup>31</sup>

The proposed Restatement recognizes this legal uncertainty safe harbor, but adopts a minority position with respect to an insurer’s right to recoup defense costs advanced pursuant to a unilateral reservation.<sup>32</sup> As such, the provisions of the proposed Restatement governing the right to recoup are apt to produce a raft of potential pitfalls that will exacerbate the problematic nature of the legal uncertainty safe harbor.<sup>33</sup> But it is not upon the foreseeable snares created by the

insurer must take action to either defend under a reservation of rights or seek declaratory relief. . . . [The insurer]’s unilateral decision and lack of action was simply a calculated gamble . . . .” *Id.* at \*10.

30. *See, e.g.*, RESTATEMENT OF THE LAW OF LIAB. INS. § 18 (AM. LAW INST., Tentative Draft No. 1, 2016) (“An insurer’s duty to defend a legal action terminates only upon the occurrence of one or more of the following events: . . . (8) Final adjudication that the insurer does not have a duty to defend the action.”).

31. *See, e.g.*, ABRAHAM & SCHWARTZ, *supra* note 8, at 584 (“In some cases, it is legally uncertain whether a suit against an insured would be covered if the allegations were true. . . . In this situation, the duty to defend and the duty to indemnify are co-extensive.”).

32. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 21 (AM. LAW INST., Tentative Draft No. 1, 2016) (“Unless otherwise stated in the insurance policy or otherwise agreed to by the insured, an insurer may not seek recoupment of defense costs from the insured, even when it is subsequently determined that the insurer did not have a duty to defend or pay defense costs.”); *id.* § 21 cmt. a (“If the insurer’s claim to recoupment is based on contract—whether a provision of the insurance policy or a subsequent agreement with the insured—it presents no legal difficulty. If neither the policy nor a subsequent agreement of the parties addresses the question, however, the viability of such a claim has been intensely controversial, and there is a split among the courts on this issue. . . . Although existing insurance policies generally do not grant insurers a right to recoupment, a slim majority of the courts . . . have held that insurers are nevertheless entitled to recover the costs of defending uncovered actions on a theory of unjust enrichment.”).

33. In jurisdictions that choose to follow the proposed Restatement, insurers may be encouraged to decline the defense of insureds more frequently in instances of legal uncertainty. *See id.* § 21 cmt. c (“There is a legitimate concern that the no-recoupment default rule may discourage insurers from undertaking a defense in some cases in which there is legal uncertainty regarding the insurer’s duty to defend.”). This concern is indeed valid. In any event, courts not in accord with a proposed requirement that express policy language or the insured’s acquiescence support a reservation of the insurer’s right to recoup defense costs in cases of legal uncertainty resolved in the insurer’s favor—now a “slim majority” according to the Comment, § 21 cmt. a—will find ample support in the proposed Restatement for a purported distinction between factual and legal uncertainty, especially in the unqualified language of the Comment to section 21 that affirms a “legal uncertainty safe harbor.” “When an insurer is defending because of *legal* uncertainty regarding its duty to defend . . . a court may later determine that the insurer did not have

problematic provisions of the proposed Restatement that address the right to recoup that this Commentary will dwell. Experience suggests that deficiencies in the proposed Restatement with respect to the legal uncertainty safe harbor addressed herein—without more, and without regard to the so-called right to recoup—merit greater scrutiny. Such attention should counsel against patent provisions that may tend to validate inequities likely to ensue as a result of an endorsed safe harbor that will vitiate an insurer’s putative defense obligation in too many instances of legal uncertainty concerning its duty to defend.

First, an insurer adhering to proposed section 13, looking only to determine whether any of the alleged facts “if proven” would trigger its duty to indemnify its insured, might very well disregard or attempt to exploit a state of unsettled law concerning the controlling construction of the terms of its policy to justify declination of its insured’s defense. An insurer looking to the pleadings and other available information to discover only whether the “allegations” against its insured, if “proven,” might trigger its duty to indemnify might be more inclined to conclude there are none, disregarding or exploiting a known state of legal uncertainty concerning construction of the terms of its policy.

For example, a complaint that alleges harm arising solely as a result of one-on-one solicitations of trade by the insured may not appear to present any allegations which, if proven, would trigger a duty to indemnify the insured under the classic “advertising injury” coverage provided by a commercial general liability (CGL) policy.<sup>34</sup> An insurer thus might be inclined to disclaim the duty to defend a suit based on such solicitations, despite a known state of unsettled law concerning the construction of the term “advertising.” An insurer should not be prompted by unsound prescriptions in the proposed Restatement to “demurrer” to a tender of its insured’s defense *because* the construction

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the duty to defend; in such a case, the insurer will have incurred costs that *it was not legally obligated to incur.* *Id.* (emphasis added).

34. See, e.g., *Scottsdale Ins. Co. v. MV Transp.*, 115 P.3d 460 (Cal. 2005). In *Scottsdale*, an insurer contended that the term “advertising,” as used in a standard CGL policy covering liability for “advertising injury,” means “widespread promotional activities usually directed to the public at large” and does not mean “one-on-one solicitation of individual customers through a competitive bidding process for tailor-made services.” *Id.* at 464 The insurer unilaterally conditioned its proffer of a defense against claims that were based upon such one-on-one solicitations upon a reservation of its right to later seek reimbursement of the costs of such defense. *Id.* at 462–64. Ultimately agreeing with the insurer’s construction of the term “advertising,” the California Supreme Court found the insurer’s duty to defend never arose, despite an acknowledged legal uncertainty concerning proper construction of the policy language governing “advertising injury” coverage, and thereupon upheld the insurer’s right to recoup the costs of defending its insured against the claims. *Id.* at 471.

of its policy will remain uncertain until controlling law is established.<sup>35</sup>

Second, certain provisions of the proposed Restatement may amplify the risk that insurers will wager on winning in court in instances of legal uncertainty. The drafters have endorsed the view that a recalcitrant insurer's refusal to undertake its duty to defend in instances of legal uncertainty should be retroactively excused if the judicial construction favored by the insurer is ultimately validated by a court.<sup>36</sup> The proposed rules thus encourage insurers to wager on the chance of prevailing on a matter of legal uncertainty. Insurers are litigious and repeat players in the judicial system and, in reality, have greater control than their customers as to when, where, and how these matters will be resolved. This is a huge advantage in the judicial casino.

Third, worse still is the presently proposed rule governing the consequent breach of the duty to defend if an insurer's proffered construction is ultimately determined to be wrong.<sup>37</sup> An insurer may be even more inclined to "roll the dice" on its proffered legal construction of its own ambiguous policy language, owing to certain provisions of the

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35. See, e.g., *id.* at 468 ("[W]here the third-party suit never presented any potential for policy coverage, the duty to defend does not arise in the first instance . . . . Moreover, the law governing the insurer's duty to defend need not be settled at the time the insurer [is called upon to defend its insured]. As several courts have explained, *subsequent* case law can establish, in hindsight, that no duty to defend ever existed. . . . By law applied in hindsight, courts can determine that no potential for coverage, and thus no duty to defend, ever existed. If that conclusion is reached, the insurer, having reserved its right, may recover from its insured the costs it expended to provide a defense which, under its contract of insurance, it was never obliged to furnish.").

36. See RESTATEMENT OF THE LAW OF LIAB. INS. § 13 cmt. f (AM. LAW INST., Discussion Draft 2015) ("An insurer facing . . . legal uncertainty has two options. First, the insurer may deny the claim. If so, the insurer's obligation to indemnify the insured against a judgment or the reasonable value of a settlement will turn entirely on whether the insurer had the duty to defend. If the insurer's legal position is correct, the insurer will not have breached the duty to defend and it will have avoided incurring the costs of defense. If the insurer's legal position turns out to be incorrect, it will have breached the duty to defend, with the consequences stated in § 19." (citation omitted)). Although this comment has been omitted from Tentative Draft No. 1, the comment is not inconsistent with the presently presented provisions of the proposed Restatement. See *supra* notes 23, 33.

37. Compare RESTATEMENT OF THE LAW OF LIAB. INS. § 19(2) (AM. LAW INST., Tentative Draft No. 1, 2016) ("An insurer that breaches the duty to defend without a reasonable basis for its conduct must provide coverage for the legal action for which the defense was sought, notwithstanding any grounds for contesting coverage that the insurer could have preserved by providing a proper defense under a reservation of rights pursuant to § 15."), with RESTATEMENT OF THE LAW OF LIAB. INS. § 19(2) (AM. LAW INST., Discussion Draft 2015) ("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.").

proposed Restatement that will factor into the insurer's assessment of the risk associated with coming out craps.

The black letter rule proposed by the Restatement relevant to the consequences of an erroneous declination of the insured's defense (section 19) forecasts that, if an insurer's proffered legal analysis of its own policy language is wrong, then the insurer in many—perhaps most—instances will be required to do only what it otherwise contractually would have been required to do in the first place.<sup>38</sup> Even the minimal deterrent value that might have been inherent in previous versions of section 19 has been devitalized by the current version of the proposed rule.<sup>39</sup>

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38. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19(2) (AM. LAW INST., Tentative Draft No. 1, 2016). The measure of damages previously prescribed by the version of section 19 set forth in the Discussion Draft basically provided for the expectation measure of damages for breach of the duty to defend, which compensates the insured for detriment which would not have been incurred had the contract been performed properly, with the additional consequence of forfeiture of a breaching insurer's defenses on the question of indemnification. RESTATEMENT OF THE LAW OF LIAB. INS. § 19(2) (AM. LAW INST., Discussion Draft, 2015). The latter aspect of the previously proposed rule—that aspect which might have created an incentive for insurers to consider more carefully declining a tendered defense—provoked strenuous objections in some quarters. See *infra* note 39. Tentative Draft No. 1 omits that aspect of the previously proposed rule that provided for forfeiture of defenses on the question of indemnification upon a bare breach of the duty to defend, and reserves the consequence of insurer liability for amounts not within the insurer's duty to indemnify to those instances where the insurer is found to have lacked a reasonable basis for its declination of the duty to defend. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19(2) (AM. LAW INST., Tentative Draft No. 1, 2016).

In cases involving a genuine issue of law, such as a split of authority nationwide creating *legal uncertainty*, an insurer relying on favorable decisions in some courts on a particular coverage question, albeit not yet determinately tested in the jurisdiction of reference, likely will not be found to have breached its implied covenant of good faith and fair dealing by reason of having declined an insured's defense while awaiting a resolution of the uncertainty. See *infra* note 42. Thus, the current version of section 19 may invite insurers to decline a defense even more frequently in instances of legal uncertainty (without regard to the inability to recoup defense costs). As presently prescribed, insurers declining a defense based on legal uncertainty established by conflicting judicial authority will weigh the risk of paying no amount greater than the insurance contract would have required from the outset (and perhaps some modicum of consequential damages)—even if the insurer's construction of its policy language is ultimately adjudicated to be incorrect—against the benefit of paying nothing for the defense of whole categories of cases pending a state-by-state judicial resolution of a legal uncertainty concerning the construction of ambiguous but standardized and ubiquitous policy provisions propounded by the insurance industry nationwide. See *infra* note 63.

39. The forfeiture of an insurer's defenses on the question of indemnification in the event of its breach of the duty to defend, as provided by the Discussion Draft of the proposed Restatement, garnered vigorous opposition. Laura A. Foggan and Karen L. Toto took the position "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." Laura A. Foggan & Karen L. Toto, *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*

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*Automatic Forfeiture of Coverage Defenses*, 68 RUTGERS U. L. REV. 65, 66 (2015). Their objection to the version of section 19 proposed by the Discussion Draft was not that it prescribed limiting (absent bad faith) an insured's remedy for breach of an insurer's duty to defend to the insurer's policy limit (thus allowing the insurer to enforce its contract after the insurer breached it). Nor was their objection that the version of section 19 proposed by the Discussion Draft prescribed holding an insurer liable for defense costs that an insurer should have paid in the first place (after depriving its insured of the bargained-for defense at the critical time the defense was needed and necessary). Instead, their principal objection to the version of section 19 proposed by the Discussion Draft was that the rule would have stripped an insurer of defenses to an obligation to indemnify its insured upon a finding that the insurer negligently breached its duty to defend. *Id.* at 66 ("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."); *see also* Charles Silver & William T. Barker, *The Treatment of Insurers' Defense-Related Responsibilities in the Principles of the Law of Liability Insurance: A Critique*, 68 RUTGERS U. L. REV. 83, 85 (2015), critiquing the same proposed remedy on the same grounds: "Remedies for breach of contract are supposed to restore parties to the position they would have come to had their counterparts performed."

Perhaps these concerns were mostly misplaced. First, an insurer's outright refusal to perform its duty to defend, in instances of legal uncertainty (like those addressed by this Commentary), nearly always will be based on the same grounds upon which the insurer relies to disclaim its potential duty to indemnify its insured. Thus, if a legal uncertainty safe harbor is recognized, then an insurer in breach of its duty to defend, absent bad faith, may be liable to pay no more than what it owed in the first place in any event. *See supra* note 38.

In instances of factual uncertainty (instances further removed from those principally discussed in this Commentary but important nonetheless), the impact of the revisions to section 19 adopted by the Tentative Draft is less clear.

On one hand, if an insurer ultimately establishes facts showing the liability of its insured to be outside the scope of the insurer's duty to indemnify, a default rule limiting the insured to "contract damages" for breach of the duty to defend will not always insulate a "merely negligent" insurer from liability for an ensuing judgment against its insured. Leaving aside the fact that negligence is a tort, a hallmark of contract damages is the rule of *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145, 145. *See, e.g.*, *Archdale v. Am. Int'l Specialty Lines Ins. Co.*, 64 Cal. Rptr. 3d 632, 649 (Ct. App. 2007) ("[T]he *Hadley v. Baxendale* rule still stands: if the damages are within the reasonable expectation of the parties at the time of contracting, they are recoverable."); *State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co.*, 88 Cal. Rptr. 246, 260 (Ct. App. 1970) (providing that a verdict against the insured is "an expectable result" of an insurer's breach of the duty to defend.); RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. j (AM. LAW INST., Tentative Draft No. 1, 2016) ("[D]amages include the foreseeable consequences of a breach of the insurer's contractual obligations.").

Indeed, assertions by Silver and Barker that "not all policyholders can afford to pay for legal services themselves after being denied coverage for defense costs by insurers" and "people who buy personal lines coverage for their automobiles or homes typically lack both the sophistication and the financial wherewithal needed to handle the defense of liability suits" appear to be correct, notwithstanding their added assertion, based on uncertain empirical evidence, that "impecunious persons [do not] face significant financial exposure in liability suits when their carriers fail to defend." Silver & Barker, *supra*, at 87, 98, 100. In the face of an empirical lack of certainty concerning exposing automobile drivers and homeowners to financial ruin upon an insurer's wrongful refusal to defend against a suit, the expectation of an insurer and its insured that such a refusal might cause that ruin means that good judgment compels affording the benefit of such

At present, forfeiture of an insurer's defenses on the question of indemnification as a consequence of breach of its duty to defend is eschewed, except in instances where the insurer breached its duty to defend "without a reasonable basis."<sup>40</sup> This exception will have limited

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doubt to policyholders. The principles involved in this conclusion are formally recognized by the proposed Restatement, even with respect to insureds who are able to mount a defense without the insurer's participation. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. d (AM. LAW INST., Tentative Draft No. 1, 2016) ("An insured without the resources and sophistication to fund and manage its defense will be harmed in obvious ways by a breach of the duty to defend, even if there is the possibility of reimbursement through filing a breach-of-contract action. An insured with adequate and readily available assets to pay for its defense may eventually be made whole if it brings a breach-of-contract claim against the insurer, but it still has lost the bargained-for expertise of the insurer in managing the litigation as well as the timely insurer-funded defense.").

Thus, in many instances—particularly with regard to insureds lacking the resources that their liability insurers promised to make available who are *unable* to mount an effective defense—an insurer breaching its duty to defend may be held liable for an ensuing judgment against its insured, not on its policy, but as damages for breach of contract. See *e.g.*, *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 179 (Cal. 1966) (in bank) ("As this court said in an analogous situation . . . : 'Having defaulted such agreement the company is manifestly bound to reimburse its insured for the full amount of any obligation reasonably incurred by him. It will not be allowed to defeat or whittle down its obligation on the theory that plaintiff himself was of such limited financial ability that he could not afford to employ able counsel, or to present every reasonable defense, or to carry his cause to the highest court having jurisdiction . . . . Sustaining such a theory . . . would tend . . . to encourage insurance companies to similar disavowals of responsibility with everything to gain and nothing to lose.'" (alterations in original) (quoting *Arenson v. Nat'l Auto. & Cas. Ins. Co.*, 310 P.2d 961, 968 (Cal. 1957) (in bank))).

On the other hand, despite the possibly mitigating effect that a broad construction of remedies for breach of contract might provide, the version of section 19 set forth by Tentative Draft No. 1 presently invites, and perhaps unwisely prescribes, the uncertain and problematic judicial conjuring necessary to impose tort remedies for a breach of contract. See, *e.g.*, *Gray*, 419 P.2d at 179 ("We reject[] . . . a 'tort' theory of damages [for an insurer's] wrongful refusal to defend. Such a theory . . . would impose upon the insured 'the impossible burden' of proving the extent of the loss caused by the insurer's breach."); *Amato v. Mercury Cas. Co.*, 61 Cal. Rptr. 2d 909, 914–15 (Ct. App. 1997) (insurer liability for indemnification irrespective of coverage based on bad faith breach of its duty to defend is *uncertain*, not guaranteed); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 202 (Cal. 1958) ("[I]f the insured has employed competent counsel to represent him, there is no ground for concluding that the judgment would have been for a lesser sum had the defense been conducted by the insurer's counsel, and therefore it cannot be said that the detriment suffered by the insured as the result of a judgment in excess of the policy limits was proximately caused by the insurer's refusal to defend."); Joseph Lavitt, *Leaving Contemporary Legal Taxonomy*, 90 DENV. U. L. REV. 213, 216–17 (2012) ("A perceived need for . . . classification arises more often than not when remedies or defenses that are typically allowed only in an action by one who has been 'wronged' are sought in an action for breach of contract.); see also *infra* notes 40, 42.

40. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19(2) (AM. LAW INST., Tentative Draft No. 1, 2016). In the Discussion Draft, the drafters also contemplated the potential for extra-contractual damages upon a "bad faith" refusal to defend. See RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. f (AM. LAW INST., Discussion Draft 2015) ("The principles stated in this section address the consequences of an ordinary breach of the duty to

application in instances of legal uncertainty, however. Frequently, as a result of multi-district splits of authority, legal uncertainty arises with respect to well-known ambiguities concerning the construction of certain provisions of standardized insurance policies applied in common scenarios.<sup>41</sup> According to the proposed Restatement, in these “easy cases,” an insurer is apt to be adjudged to have had a reasonable basis for an erroneous declination of its obligation to defend its insured.<sup>42</sup>

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defend. Additional damages may be available if the breach meets the standard for bad faith.”). Regrettably, the elastic nature of “bad faith” adjudications easily can be misapprehended. For example, the reporters refer to a notable California jurist’s opinion that: “[I]f a potential for coverage exists (i.e., there is a factual dispute over coverage) then the insurer has a duty to defend and its failure to do so, whatever its reason, will result in bad faith liability. Or, to put it another way, the failure or refusal to provide a defense when a potential for coverage exists constitutes bad faith as a matter of law . . . .” RESTATEMENT OF THE LAW OF LIAB. INS. § 19 reporters’ note b (AM. LAW INST., Tentative Draft No. 1, 2016) (citing Walter Croskey, *Genuine Dispute Doctrine in Third Party Bad Faith Cases*, 23 CAL. LITIG. 10 (2010)). The reporters add: “[I]f an insurer *unreasonably* fails to defend, it has breached the implied covenant of good faith and fair dealing.” *Id.* § 19 reporters’ note c (quoting *Campbell v. Superior Court*, 52 Cal. Rptr. 2d 385, 393 (Ct. App. 1996)). The implication that a failure to defend in instances of factual uncertainty *per se* will be considered to have been without a reasonable basis is incorrect. The *Campbell* court, reversing a trial court order sustaining without leave to amend a demurrer by an insurer to a complaint for bad faith refusal to defend its insured, took great care to instruct the lower court to infer from its opinion no implication of *per se* liability for bad faith. *See id.* at 394 (“Recognition that a refusal to defend *can* result in liability for breach of the implied covenant does not result in a situation in which an insurer must defend all claims at the risk of incurring expansive liability. . . . [B]reach of the implied covenant requires unreasonable conduct or an action taken without proper cause.”); *see also* *Congleton v. Nat’l Union Fire Ins. Co.* 234 Cal. Rptr. 218 (Ct. App. 1987) (finding bad faith implies unfair dealing, not mistaken judgment).

41. *See infra* note 63.

42. *See, e.g.*, RESTATEMENT OF THE LAW OF LIAB. INS. § 19 cmt. g (AM. LAW INST., Tentative Draft No. 1, 2016) (“Easy cases in which there is a reasonable basis include those in which the insurer is pressing a legal position that has been followed by courts in other jurisdictions but has not yet been decided in the jurisdiction in question.”); *State Farm Fire & Cas. Co. v. GP W., Inc.*, No. 15-00101, 2016 WL 3189187, at \*16 (D. Haw. June 7, 2016) (“[A]n insurer that relies on governing law in denying a claim cannot be said to have acted in bad faith.”); *Phila. Indem. Ins. Co. v. Youth Alive, Inc.*, 732 F.3d 645, 649–50 (6th Cir. 2013) (“Uncertainty as to application of insurance policy provisions . . . is a reasonable and legitimate reason for an insurance company to litigate a claim.’ Thus, when an insured’s claim implicates an ‘unresolved legal issue’—such as when recovery under an insurance policy is ‘dependent upon a legal issue of first impression in Kentucky courts,’ the claim is ‘fairly debatable as a matter of law and will not support a claim of bad faith.’ . . . [A] bad-faith claim is precluded as a matter of law as long as there is room for reasonable disagreement as to the proper outcome of a contested legal issue, even if in hindsight it was ‘fairly predictable’ that the dispute would be resolved against the insurer.” (citations omitted) (first quoting *Farmland Mut. Ins. Co. v. Johnson*, 36 S.W.3d 368, 375, 377 (Ky. 2000); then quoting *Empire Fire & Marine Ins. Co. v. Simpsonville Wrecker Serv., Inc.*, 880 S.W.2d 886, 891 (Ky. Ct. App. 1994)); and then quoting *Terletsky v. Prudential Prop. & Cas. Ins. Co.*, 649 A.2d 680, 689–90 (Pa. Super. Ct. 1994) (“[The insurer’s] actions . . . were reasonably based. . . . At the time . . . Pennsylvania law

Fortunately, salutary provisions of the proposed Restatement may neutralize or even counteract the dangerous and pernicious incentives created by the proposed provisions identified above. Uncannily, if the draft provisions regarding “ambiguity” found elsewhere in the proposed Restatement are read closely, elevated to greater importance and afforded more consistent application throughout, then the unfitting nature of the legal uncertainty safe harbor for recalcitrant insurers will be exposed and rendered analytically untenable.

The key to undoing the legal uncertainty safe harbor will be found in the realization that “legal uncertainty” should be understood as just another way of saying that the terms of the insurer’s policy are ambiguous as applied to the circumstances.<sup>43</sup> For example, consider the approach the proposed Restatement suggests with respect to a frequently litigated topic—the appropriate construction of the term “damages” as used in the insuring clause employed by most standard liability insurance policies.<sup>44</sup>

Whether a court construes the term “damages” to include amounts expended by an insured in response to administrative orders to remediate hazardous conditions may be of determinative importance to a liability insurer’s duty to indemnify its insured (and thus, this construction may have a determinative effect on the insurer’s duty to defend). The proposed Restatement unequivocally recognizes that, in this context, the undefined term “damages” may have no plain meaning

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regarding the [coverage] issue was unsettled. . . . [The insurer’s] claims manager . . . admitted that although he was familiar with [a case favorable to the insured] he was also aware of federal cases that disagreed. . . . [H]e testified that he was unaware of any Pennsylvania . . . cases that addressed this specific [coverage] issue. Therefore, he believed that [the insurer] had a reasonable basis for . . . disputing payment . . . . Moreover, [the insurer’s] actions were reasonably based because [the insurer] obtained advice of outside counsel with regard to the [insureds’] claims. . . . [W]e conclude that [the insurer] had a reasonable basis for disputing [coverage and the insureds] have not proven that [the insurer] acted in bad faith.”).

43. See, e.g., *Hugo Boss Fashions, Inc. v. Fed. Ins. Co.*, 252 F.3d 608, 620 (2d Cir. 2001) (“There are at least three kinds of uncertainty that can give rise to such a duty to defend. The first is factual: did the injury occur in a time, place, or way that is covered by the policy? The second is legal: will the cases governing the insurance policy be read to impose coverage in a given situation? The third arises from the existence of *contra proferentem*: will the terms of the contract of insurance be deemed to give rise to an ambiguity that must be read against the insurer or will they be held to be clear enough to avoid the presumption? Each of these uncertainties will ultimately be resolved by courts or juries—and often in favor of the insurer, thereby precluding coverage and the duty to indemnify. But until they are, the insurer cannot avoid its duty to defend.”).

44. See RESTATEMENT OF THE LAW OF LIAB. INS. § 4 cmt. m, illus. 5 (AM. LAW INST., Tentative Draft No. 1, 2016) (quoting a typical CGL insurance policy that “obligates the insurer ‘to pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of . . . property damage to which this insurance applies, caused by an occurrence.’” (alteration in original)).

and thus states: “In determining the meaning of the term ‘damages,’ the court should take into account the fact that the term is not defined in the policy and that the insurer could have included a definition that incorporated the distinction between legal and equitable remedies urged by the insurer.”<sup>45</sup>

In other words, in the view of the proposed Restatement, construction of the undefined term “damages” may be “legally uncertain” in the described circumstances because the term “damages” is “ambiguous” as applied, and, therefore, the proper construction of the term should await an appropriate determination by a court, subject to the appropriate maxims of legal construction.<sup>46</sup> So far, so good.

Moreover, in the spirit of fairness to which one hopes most courts will adhere, inherent in the provisions of the proposed Restatement one finds a frank call for a fair judicial accounting of whether an insurer demonstrably and easily could have made the ambiguous term more plain (or, less ambiguous).<sup>47</sup> Again, so far, so good: even better.

Strikingly, however, the proposed Restatement does not link these fair prescriptions for principled legal construction that accounts for curable ambiguity to an insurer’s responsibility for declination of its duty to defend based on a legal uncertainty for which the insurer is responsible. If the responsibility for an ambiguity lies with the insurer—for example, legal uncertainty about the construction of the term “damages,” a matter at the heart of the insuring clause—then fairness would suggest that the insurer should bear the risk of that uncertainty and honor its uncertain obligation under the policy to defend an insured in the interim until its duty to do so is legally excused or established. If an insurer’s obligation to indemnify might, or might not arise, then the duty to defend is usually deemed to be triggered. After all, *the duty to defend is broader than the duty to indemnify*.

Despite the fact that the proposed Restatement recognizes that an

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45. *Id.*

46. *Id.* § 4 cmt. m (highlighting the undefined term “damages” to illustrate ambiguity: “In determining the meaning of an ambiguous term, it is appropriate to consider the difficulty of redrafting the insurance policy to more plainly express the meaning urged by the drafting party”); ABRAHAM & SCHWARTZ, *supra* note 8, at 584 (referencing the undefined term “damages” to illustrate “legal uncertainty”: “*Refuse to Defend: Legal Uncertainty Versus Factual Uncertainty*. In some cases, it is legally uncertain whether a suit against an insured would be covered if the allegations were true. For example, the complaint may allege liability for the cost of pollution cleanup at a time when the jurisdiction has not yet ruled on the question . . . whether cleanup liability constitutes ‘damages’ under the defendant’s CGL insurance policy.”).

47. RESTATEMENT OF THE LAW OF LIAB. INS. § 4 cmt. m, illus. 5 (AM. LAW INST., Tentative Draft No. 1, 2016) (“[A] court should take into account [whether a policy] term is . . . defined . . . and [whether] the insurer could have included a definition . . .”).

ambiguity in the terms of an insurer's policy may be directly attributable to the failure to make a standardized provision more clear, however, there appears to be no concomitant recognition that such ambiguity might be employed to justify a decision by an insurer to decline its duty to defend its insureds in jurisdictions where the construction of the same standardized provision remains unsettled. It is simply not enough to say that if the rules pertaining to the resolution of "ambiguity" are properly applied, then the insurer ultimately will lose in court and all will be well. That is not the way it works.<sup>48</sup>

This is not a hypothetical assertion. Once again, the illustration concerning the construction of the terms "damages" is salient. This illustration is based on an issue that came before the California Supreme Court in a seminal and important case.<sup>49</sup> When confronted with the issue described concerning construction of the term "damages," the California Supreme Court did not find the term "damages" to be ambiguous.<sup>50</sup> Instead, the court found the term to have a clear

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48. The distinction between factual and legal uncertainty appears to be based, at least in part, on an implicit premise that there is "one right answer" with respect to the construction of an ambiguous insurance policy provision as applied to the circumstances, i.e., the proper construction exists, but awaits judicial discovery. If a court ultimately agrees with an insurer's proffered construction of ambiguous policy language, this line of reasoning seems to assume, then the policy never "covered" the loss because this "one right answer" existed from the outset. Even for Ronald Dworkin, however, an Olympian judge named Hercules could not discover the one right answer to a question of judicial construction with which all other judges would agree: "For every route Hercules took from [a] general conception to a particular verdict, another lawyer or judge who began in the same conception would find a different route and end in a different place . . ." RONALD DWORIN, *LAW'S EMPIRE* 412 (1986); *see also* John Finnis, *On Reason and Authority in Law's Empire*, 6 *LAW & PHIL.* 357, 376 (1987) ("[I]n legal systems like ours, there will be no one answer which, because uniquely right, should be described as '*the law governing the case.*'"). Courts seldom uniformly agree on "one right answer" to a question of construction involving ambiguous insurance policy language. Thus, whether a loss is "covered" by the ambiguous terms of an insurance policy often will depend upon the courts and the jurisdiction in which the matter is litigated. A legal principle that declares in instances of legal uncertainty resolved in an insurer's favor that a loss was "never covered" is suspect—unless qualified to the point of near inconsequentiality (e.g., by reference to the level of the court deciding the matter, the extent to which courts may judicially estop insurers to preclude them from adopting different positions in different courts and jurisdictions with respect to identical policy provisions, *et cetera*).

49. *Certain Underwriters at Lloyd's of London v. Superior Court*, 16 P.3d 94, 103 (Cal. 2001) (holding that the term "damages" as used in the standard liability insurance clause "is limited to money ordered by a court").

50. *See id.* at 106, 108 ("The duty to indemnify involves 'damages,' clearly so, and not something equivalent to damages . . . . To rewrite the provision imposing the duty to indemnify in order to remove its limitation to money ordered by a court might compel insurers to give more than they promised and might allow insureds to get more than they paid for, thereby denying their 'general[] free[dom] to contract as they please[]' . . . . It is conceivable that to rewrite the provision thus might result in providing society itself with benefits that might outweigh any costs . . . . It is conceivable. But unknown. Knowledge

meaning<sup>51</sup> based on context<sup>52</sup> and the court's perception of the meaning ascribed to the term "damages" in "the 'legal . . . culture' of the judicial sphere and the 'broader culture' of the 'world at large.'"<sup>53</sup> The court soundly rejected an assertion to the contrary that widespread judicial disagreement in analogous contexts about the meaning of the term "damages" established ambiguity as a matter of law.<sup>54</sup> Refusing to elevate concerns about "public policy" over professedly strict

'depend[s] in large part on' what we are ill suited for, that is, the 'amassing and analyzing of complex and extensive empirical data.' Without such knowledge, we could not proceed." (alterations in original) (citations omitted) (quoting *Aerojet-Gen. Corp. v. Transp. Indem. Co.*, 948 P.2d 909, 932 (Cal. 1997))).

51. *Id.* at 105-07 ("Consequently, the insurer's duty to indemnify the insured for 'all sums that the insured becomes legally obligated to pay as damages' is limited to money ordered by a court. It does not extend to all sums, or even any sum, that the insured becomes legally obligated to pay other than as damages. Surely not to all sums, or even any sum, that the insured may be said to become legally obligated to pay as a result of harm. . . . [T]he duty to indemnify does not extend to any expenses required by an administrative agency pursuant to an environmental statute . . . . Our reason is that expenses required by an administrative agency pursuant to an environmental statute . . . do not constitute money ordered by a court.").

52. In *Certain Underwriters at Lloyd's of London v. Superior Court*, the court turned around the old adage that "the duty to defend is broader than the duty to indemnify" in a novel way. In a prior decision, the California Supreme Court found that an insurer's duty under a CGL policy to defend its insured with respect to a "suit" seeking damages was limited to a civil action prosecuted in a court. See *Foster-Gardner, Inc. v. Nat'l Union Fire Ins. Co.*, 959 P.2d 265, 279 (Cal. 1998). In *Certain Underwriters at Lloyd's of London*, the court declared:

Our belief about the duty to indemnify and its limitation to money ordered by a court is sufficiently supported when we look to what we may call *Foster-Gardner's* "syllogism" alone.

The duty to defend is broader than the duty to indemnify. The duty to defend is not broad enough to extend beyond a "suit," i.e., a civil action prosecuted in a court, but rather is limited thereto. A fortiori, the duty to indemnify is not broad enough to extend beyond "damages," i.e., money ordered by a court, but rather is limited thereto. "It is . . . well settled that because the duty to defend is broader than the duty to indemnify," a determination that "there is no duty to defend automatically means that there is no duty to indemnify."

16 P.3d at 103-04 (alteration in original) (quoting *New York v. Blank*, 745 F. Supp. 841, 844 (N.D.N.Y. 1990), *aff'd*, 27 F.3d 783 (2d Cir. 1994)).

53. See *Certain Underwriters at Lloyd's of London*, 16 P.3d at 104 ("The full context of the provision imposing the duty to indemnify includes, under the narrower focus, the standard policy . . . provision imposing the duty to defend and, under the wider focus, the standard policy within the 'legal . . . culture' of the judicial sphere and the 'broader culture' of the world at large." (alteration in original) (quoting *Kopp v. Fair Political Practices Comm'n*, 905 P.2d 1248, 1291 (Cal. 1995) (in bank) (Mosk, J., concurring))).

54. See *id.* at 106, 110-11 ("Expressly or impliedly, [other courts] have treated the provision imposing the duty to indemnify as 'ambiguous[]' . . . . We arrive at our conclusion not unaware that other courts have held or stated, in terms or in effect, that the duty to indemnify is not limited to money ordered by a court, but may extend to expenses required by an administrative agency pursuant to an environmental statute. For the reasons that we have stated, we cannot, and will not, follow." (footnote omitted)).

construction of the subject policy language,<sup>55</sup> the court presumed a “bright-line rule” delineating an unambiguous construction of the term “damages” in all contexts would promote judicial efficiency.<sup>56</sup>

Perhaps most strikingly, in this instance, the court disregarded evidence that the legal uncertainty surrounding construction of the policy language at issue easily could have been avoided. The evidence showed that the insurer could have eliminated the asserted ambiguity by choosing to utilize an available, clearer insuring agreement.<sup>57</sup> Yet, the California Supreme Court did not, as the proposed Restatement prescribes, take into account the easily curable nature of the ambiguity before it.<sup>58</sup>

The issue here in a policy sense is not the way that the California Supreme Court resolved an ambiguous contract term, however.<sup>59</sup> Nor is the principal issue the fact that the California Supreme Court was swimming against the tide of decisions in other jurisdictions. (The court was entirely unconcerned about the number of courts that disagreed

55. *See id.* at 108 (“In arriving at our conclusion, we decline to rewrite the provision imposing the duty to indemnify in order to remove its limitation to money ordered by a court. We will not do so for the insured itself, in order to shift to the insurer some or all of the potentially substantial costs that might be imposed on the insured as the outcome of a proceeding conducted before an administrative agency pursuant to an environmental statute. Neither will we do so for considerations of public policy . . .”).

56. *Id.* at 107 (“In its limitation to money ordered by a court, the provision imposing the duty to indemnify commends itself to society generally as laying down a bright-line rule. It has a tendency to promote fairness and efficiency in the judicial sphere. By increasing certainty and decreasing uncertainty about the duty to indemnify, it serves to deter some litigation on the issue and to conclude what it does not deter expeditiously and soundly.”).

57. *Id.* at 115 (Kennard, J., dissenting) (“Had they intended such limitations [to indemnify only money awarded by a court], the insurers could easily have agreed to pay on behalf of the insured, for example, ‘all sums that the insured becomes legally obligated by final judgment to pay as damages.’ The insurers did not do so in the primary policy. Although language of this sort does not appear in the indemnity provision of the primary policy, it does appear in another CGL policy written and issued on the same day by the same carrier to the same insured. In this other policy, which provided excess coverage, the carrier promised to pay ‘all sums which the insured shall by law become liable to pay and shall pay *or by final judgment be adjudged to pay* . . . as damages . . .’ The italicized language in the excess policy shows that the insurer understood how to restrict the indemnity obligation to sums that the insured was required to pay as damages by final judgment (that is, sums ordered by a court in a civil action) when that was its intent. This limitation should not be read into a policy from which the insurer appears to have deliberately omitted it.” (alterations in original)).

58. *See infra* note 67.

59. Some may counter that the view of the California Supreme Court was wrong (or contrary to the weight of the authority) or that the issue was actually decided by an earlier case, *see supra* note 52, but that is not the important point here. The important point here is that the proposed Restatement should not disentangle principles governing the appropriate construction of insurance contracts in instances of ambiguity from principles governing the duty to defend.

with its opinion.)<sup>60</sup>

The pertinent question for the drafters of the proposed Restatement is whether endorsing a legal uncertainty safe harbor makes sense in light of this case study, especially given the drafters' frank acknowledgment that ambiguities in the application of policy language will inevitably arise.<sup>61</sup> After all, ambiguity concerning the construction of the term "damages" arose after more than a century of incorporation of this term in the key insuring clause of almost every liability insurance policy.<sup>62</sup>

The "damages" question vividly illustrates the way insurers have proceeded in the past in instances of ambiguity associated with the construction of standardized policy forms. The prospect that the California Supreme Court might adopt a minority position was certainly not certain at the time judicial construction of the term "damages" was legally uncertain in California. Indeed, a significant number of courts had ruled against the insurers' proffered construction. Yet, insurers were willing to test the courts in jurisdiction after jurisdiction, awaiting a favorable decision, which they ultimately obtained in a major market like California.

If the proposed Restatement is adopted as is, we therefore might expect going forward that when a nationwide split of authority arises on some issue of policy construction, given an absence of controlling

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60. See *Certain Underwriters at Lloyd's of London*, 16 P.3d at 106 ("We are not unaware, however, that yet other courts are contra. Neither are we unaware that such other courts are more numerous. Their number, however, adds nothing to their weight. . . . For, whether their discussion fills many pages or amounts only to a few words, they have each failed to consider the provision imposing the duty to indemnify in its full context. Because of their failure, whatever discussion they set forth proves lacking in persuasive force." (footnote omitted)).

61. See RESTATEMENT OF THE LAW OF LIAB. INS. § 4 cmt. h (AM. LAW INST., Tentative Draft No. 1, 2016) ("It should be noted . . . that the aim of the [*contra proferentem*] rule is not the elimination of all ambiguity. Here the analogy to tort law is helpful. Just as it is not possible for the incentive provided by a tort liability rule to eliminate the possibility of all accidents, it is not possible for the incentive provided by a *contra proferentem* rule to eliminate all possibility of ambiguity. Even insurance policy terms that are relatively simple and clear on their face can become ambiguous when applied to a particular claim. The cost, to insurers and policyholders, of attempting to draft policies that specifically and unambiguously address every conceivable contingency would be prohibitive.").

62. See, e.g., *Finley v. United States Cas. Co.*, 83 S.W. 2, 3 (Tenn. 1904) ("There is a distinction made by the authorities between a contract of indemnity against liability for damages and a simple contract of indemnity against damages. In the former case it has very generally been held that an action may be brought, and a recovery had, as soon as the liability is legally imposed, while in the latter there is no cause of action until there is actual damage." (quoting *Fenton v. Fid. & Cas. Co. of N.Y.*, 56 P. 1096, 1097 (Or. 1899))); James M. Fischer, *Broadening the Insurer's Duty to Defend: How Gray v. Zurich Insurance Co. Transformed Liability Insurance into Litigation Insurance*, 25 U.C. DAVIS L. REV. 141, 146 n.12 (1991).

judicial authority on the issue, insurers, perhaps relying on and prompted by the proposed Restatement, may disclaim the defense of their insureds in even more instances. This sort of nationwide uncertainty has not been uncommon and unfortunately almost always has been a product of ambiguity created by the terms of industry-promulgated, standardized insurance forms which easily could have been amended to resolve the uncertainty and to avoid costly litigation.<sup>63</sup>

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63. In addition to the construction of the term “damages,” *see supra* note 46, another example of pervasive ambiguity was the so-called “sudden and accidental” exception that applied at one time to a category of exclusions in most liability insurance policies pertaining to injury caused by the discharge of pollutants. Construction of this phrase raged on and on in the courts for years. *See, e.g.*, David A. Gaudio, Comment, *A Matter of Interpretation: The Judicial Quagmire Concerning the Sudden and Accidental Exception to the Pollution Exclusion Clause*, 2 VILL. ENVTL. L.J. 373, 385, 387 (1991) (“Quite simply, the courts [could not] agree on the definition of a ‘sudden and accidental’ polluting event. . . . The fact that different courts . . . read the exact same policy language [to] reach diametrically opposite conclusions seem[ed] to suggest that the pollution exclusion clause [was] at best, tenuously reliable in its application as a modification of CGL policies.”). The proposed Restatement has recognized this ambiguity. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 2 cmt. b, illus. 1 (AM. LAW INST., Tentative Draft No. 1, 2016) (“The interpretation of the pollution exclusion in these circumstances is a question of law for the court . . .”). Yet, the proposed Restatement, read as a whole, does not explicitly and appropriately link an acknowledged legal uncertainty, such as legal uncertainty concerning the meaning of the term “sudden,” to an insurer’s duty to defend its insureds until such uncertainty is resolved (at least in the jurisdiction of reference), and does not address whether proposed consequences associated with breach of an insurer’s duty to defend would sufficiently deter insurers from choosing to decline that obligation while awaiting a dispositive resolution in various jurisdictions expected to reach differing conclusions concerning the application of ambiguous policy provisions.

Yet another example of widespread ambiguity has been the so-called “trigger” of coverage under a standard form liability insurance policy that applies to loss that “occurs” during the policy period. In *Montrose Chemical Corporation of California v. Admiral Insurance Co.*, the court of appeals noted that, in and about 1966, “the drafters of the ‘occurrence’ policy and experts advising the industry regarding its interpretation contemplated coverage under successive policies for progressive continuing injuries and damage. Any suggestion that an insured’s identical interpretation is unreasonable is absurd.” 5 Cal. Rptr. 2d 358, 369 (Ct. App. 1992), *aff’d*, 913 P.2d 878 (Cal. 1995). Yet, the insurance industry, mainly in the last decades of the twentieth century, vigorously litigated this very issue on a nationwide basis. The long battle resulted in conflicting rulings, especially because insurers proffered different constructions of the same policy provisions in different jurisdictions based solely on expediency. *See, e.g.*, Amicus Curiae Mid-America Legal Foundation’s Brief in Support of Appellant Montrose Chemical Corporation of California, *Montrose Chem. Corp. of Cal. v. Admiral Ins. Co.*, 913 P.2d 878 (Cal. 1995) (in bank) (No. S026013), 1992 WL 12024446, at \*2–4 (“Members of the insurance industry at various times have argued for, and the courts have applied, four or more triggers of coverage in actions involving insurance coverage for progressive or continuous injuries or damage. The ‘discovery-only’ trigger of coverage (sometimes also referred to as the manifestation trigger) now advanced by Admiral Insurance Company (Admiral) is presently the most restrictive of these different theories. . . . In order to protect the courts from being misled, insurance companies must be prevented from contradicting positions taken by them in other insurance coverage actions. When a

An insurer with everything to gain and not much to lose might be even more indifferent to the national dysfunction and delay created by unresolved ambiguities—which the insurer, in many instances, could have ameliorated—in light of the weak consequences the proposed Restatement contemplates probably will ensue if an insurer’s proffered construction of its ambiguous policy language is ultimately rejected. A rational insurer might choose to refuse to defend its insureds preceding the ultimate resolution of a given coverage question as a matter of law in each state where the issue remains uncertain, especially because state by state differences may provide a “reasonable basis” for any such choice.<sup>64</sup> Insurers under these circumstances may perceive a greater incentive to risk a negative outcome, betting on a win—even on the possibility of a decision against the weight of authority in other jurisdictions, just like the decision described above in California<sup>65</sup>—that will retroactively vindicate that wager.

Fortunately, the “damages” illustration not only uncovers the problem but also points to a possible solution. The provisions of the proposed Restatement and associated commentary governing the resolution of ambiguity in the terms of an insurance policy are outstanding.<sup>66</sup> These rules seek to promote fairness and efficiency in the drafting of insurance policies by requiring the offering party to account for ambiguous policy language that could have been avoided by more careful drafting.<sup>67</sup> The drafters of the proposed Restatement buttress

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policyholder seeks coverage, insurance companies generally argue for a restrictive trigger of coverage. But when it has suited their own pecuniary interests, insurance companies themselves—often seeking contribution or subrogation—have argued for the application of the continuous trigger of coverage so that they, too, can obtain the full proceeds to which they claim they are entitled. . . . [A]s indicated by trigger of coverage positions asserted by numerous members of the insurance industry in other actions throughout this country and in statements of intent in connection with the drafting and promulgation of standard-form policy provisions, the ‘discovery-only’ trigger of coverage is inconsistent and inappropriate in situations involving progressive or continuous loss or damage. Insurance companies should not be permitted to contradict themselves in court on the meaning of standardized insurance policy language when it suits their economic interest to do so.” (footnote omitted) (emphasis omitted).

64. See *supra* note 42.

65. See *supra* notes 49–60 and accompanying text.

66. RESTATEMENT OF THE LAW OF LIAB. INS. § 4 (AM. LAW INST., Tentative Draft No. 1, 2016). The full text of section 4 is included in the Appendix.

67. See *id.* § 4 cmt. m (“In determining the meaning of an ambiguous term, it is appropriate to consider the difficulty of redrafting the insurance policy to more plainly express the meaning urged by the drafting party, ordinarily the insurer, taking into account that some residual risk of ambiguity is to be expected. The easier it would be for the drafter to state that meaning more plainly, the more likely it is that the other party’s proposed meaning is the meaning that a reasonable policyholder would give to the term. Like the presumption in favor of plain meaning, this approach creates an incentive for insurers to draft insurance policy terms that provide clear guidance regarding the scope of

this signal by recognizing the long-standing view that *contra proferentem*<sup>68</sup> is a useful legal construct to allocate the inevitable costs associated with uncertain insurance policy provisions.<sup>69</sup> And, perhaps most beneficially, the proposed Restatement calls for construction of ambiguous policy language with the goal in mind to “effect[] the dominant protective purpose of insurance” and “provid[e] clear guidance on the meaning of insurance policy terms in order to promote, among other benefits, fair . . . interpretation of insurance policies.”<sup>70</sup>

In short, the proposed Restatement urges courts to provide “the supplier of the [insurance contract] terms the incentive to take all reasonable steps to eliminate ambiguity in the drafting of [such] terms” and rightly notes that,

through the application of the *contra proferentem* rule, [the costs associated with ambiguity will be] ultimately spread over all policyholders rather than borne by any individual insured.

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the risks insured under their policies.”).

68. *See id.* § 4 cmt. h. (“The rule that an ambiguous contract term should be interpreted against the party that supplied the term is commonly referred to in insurance law sources by its Latin name, *contra proferentem*, which means ‘against the offeror.’ In the context of standard-form insurance policy terms the insurer is so regularly the party supplying the form that courts often describe the *contra proferentem* rule as meaning that an ambiguous policy is interpreted in favor of coverage. The standard justification for the *contra proferentem* rule builds on the idea that the supplier of a term in a contract is generally in the best position to avoid ambiguity in the wording of the terms, since the supplier drafted or, at the very least, chose to offer a contract containing that term. This rationale applies especially to situations involving standard-form terms, where one party supplies the terms and the other party either accepts or rejects them but is not given the option of suggesting alternative wording. The *contra proferentem* rule gives the supplier of the terms the incentive to take all reasonable steps to eliminate ambiguity in the drafting of terms.”).

69. *See id.* § 4 cmt. i. (“In addition to creating positive drafting incentives, the *contra proferentem* rule allocates to the party supplying the term the residual risk of unavoidable ambiguity. This allocation of risk is especially appropriate in the insurance context, where the parties supplying terms generally are insurance companies whose primary function is the spreading of risks. Thus, the risk of unavoidable ambiguity in insurance policy terms is, through the application of the *contra proferentem* rule, ultimately spread over all policyholders rather than borne by any individual insured. There is also a fairness argument that supports imposing the costs of ambiguity upon the party that benefited from having its preferred term in the insurance policy.”).

70. *Id.* § 2 cmt. c. (“The appellate oversight and public guidance provided by judicial decisions interpreting liability insurance policies promote the objectives of liability insurance policy interpretation. These objectives include: effecting the dominant protective purpose of insurance; facilitating the resolution of insurance-coverage disputes and the payment of covered claims; encouraging the accurate description of insurance policies by insurers and their agents; and providing clear guidance on the meaning of insurance policy terms in order to promote, among other benefits, fair and efficient insurance pricing, underwriting, and claims management. These objectives provide guidance for the interpretation of insurance policies.”).

There is also a fairness argument that supports imposing the costs of ambiguity upon the party that benefited from having its preferred term in the insurance policy.<sup>71</sup>

If not the duty to defend, then just what is a “dominant protective purpose of [liability] insurance?”<sup>72</sup> If not a maxim of contract construction that will deter the promulgation of ambiguous insurance policy provisions—drafted in a milieu exempted from antitrust considerations by federal law and propounded on a “take it or leave it basis”<sup>73</sup>—then just what will “*contra proferentem*” accomplish? If not to encourage the imposition of the costs of ambiguity upon an industry willing to expend millions in attorneys’ fees rather than amend ambiguous policy provisions to eliminate an acknowledged ambiguity, then for what purpose does the proposed Restatement declare that courts should take the ease of amendment into account? Will the costs of ambiguity be imposed upon the party that will benefit from having its preferred terms in an insurance policy if an insurer proffering policy terms known to be ambiguous may be better off by refusing to defend

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71. *Id.* § 4 cmts. h, i.

72. *Id.* § 2 cmt. c.

73. In 1971, a consortium of insurers formed the Insurance Service Office, Inc. (“ISO”). See *ISO Homepage*, VERISK ANALYTICS, <http://www.verisk.com/iso-home/about-iso/about-iso.html> (last visited June 10, 2016) (providing information about services provided by the ISO). Among its other functions, “ISO maintains a specialized staff of lawyers and insurance experts . . . [ISO] design[s] and review[s] . . . standardized policy language, rules, cost information, and other products to make sure they comply with all statutory, judicial, and regulatory requirements . . . review[s] and respond[s] to changes in the law, court decisions, and regulatory orders[,] file[s] [its] products with regulators, . . . and actively pursue[s] approvals.” *Helping Insurers Comply with Legal and Regulatory Requirements*, VERISK ANALYTICS, <http://www.verisk.com/iso/about-iso/iso-services-for-property-casualty-insurance/helping-insurers-comply-with-legal-and-regulatory-requirements.html>; see, e.g., *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 772 (1993) (“To understand how the defendants are alleged to have pressured the targeted primary insurers to make . . . changes, one must be aware of two important features of the insurance industry. First, most primary insurers rely on certain outside support services for the type of insurance coverage they wish to sell. Defendant Insurance Services Office, Inc. (ISO), an association of approximately 1,400 domestic property and casualty insurers . . . is the almost exclusive source of support services in this country for CGL insurance. . . .”). Such activities have been shielded from the scope of federal antitrust regulation by reason of the McCarran-Ferguson Act. See Joseph Lavitt, *The Doctrine of Efficient Proximate Cause, the Katrina Disaster, Prosser’s Folly, and the Third Restatement of Torts: Cracking the Conundrum*, 54 LOY. L. REV. 1, 45 n.189 (2008) (“In *United States v. South-Eastern Underwriters Ass’n*, 322 U.S. 533 (1944), the Court . . . declared insurers potentially liable under the Sherman Act [which was enacted in 1890.] . . . In response to this ‘crisis,’ Congress almost immediately passed the McCarran-Ferguson Act in 1945, which provides generally that an insurer subject to state regulation is exempt from the provisions of the Sherman Act, the Clayton Act, and the Federal Trade Commission Act.”).

its insureds while seeking piecemeal and inconsistent construction of such terms nationwide?<sup>74</sup>

If the provisions of the proposed Restatement do not deter the prospect of insurer forum shopping to validate a proposed construction of ambiguous language, then of what use is urging courts to “provid[e] clear guidance on the meaning of insurance policy terms [and] fair . . . interpretation of insurance policies?”<sup>75</sup>

The answer to all these questions is the better reasoned view that unresolved legal uncertainty concerning an insurer’s duty to indemnify its insured does not excuse its duty to defend; such uncertainty *establishes* that duty until the uncertainty is removed.

Here, it is important to pause to note that legal principles governing “ambiguity” do not invite an insured to concoct any frivolous construction to pretend there is an “ambiguity” in policy language that, in context, is reasonably clear and understandable.<sup>76</sup> Insurers have nothing to fear from a frank accounting for ambiguous policy language. A court always must determine whether an insured’s proffered construction is “reasonable” (even if ultimately incorrect) before the rules governing ambiguity will be triggered. Insurers need not worry that courts will unjustly impose upon them liability for breach of the duty to have defended in too many cases based on an insured’s unreasonable and frivolous proffered construction of clear insurance policy terms.<sup>77</sup> There is no shortage of *bona fide* ambiguities that insurers have tested in the courts nationwide, sometimes arguing one construction, sometimes another, based on expediency.<sup>78</sup> It is to this circumstance that this critique primarily is focused.

It is equally important to acknowledge that there is a limit to what

74. Indeed, the provisions of the proposed restatement profess a preference for the “development of uniform, predictable meanings of insurance terms.” See RESTATEMENT OF THE LAW OF LIAB. INS. § 2 cmt. j (AM. LAW INST., Tentative Draft No. 1, 2016).

75. *Id.* § 2 cmt. c.

76. See, e.g., *Penn-America Ins. Co. v. Mike’s Tailoring*, 22 Cal. Rptr. 3d 918, 920 (2005). In *Mike’s Tailoring*, the policy excluded “[w]ater that backs up from a sewer or drain.” *Id.* The insured contended that the exclusion applied only to water damage. See *id.* The court held that, “given [a] common sense interpretation,” the exclusion applies to damage from “the sewage that inevitably accompanies the water in a sewer.” *Id.*

77. See, e.g., *Hugo Boss Fashions, Inc. v. Fed. Ins. Co.*, 252 F.3d 608, 620–21 (2d Cir. 2001) (“There are, of course, cases in which the policy is so clear that there is no uncertainty in fact or law, and hence no duty to defend. And in cases where there is doubt as to the applicability of a policy to a claim, that uncertainty can be resolved long before the insurer has had to expend significant funds defending the insured in the underlying litigation.” (footnote omitted)). Moreover, if repeated instances of a judicial construction to which insurers object occur, insurers can amend standard form policies to account for the putatively improperly found ambiguity: precisely the outcome the proposed Restatement, at least in some proposed provisions, endorses and encourages. See *supra* note 67.

78. See *supra* note 63.

the Restatement can and cannot accomplish. The absence of judicial consensus on certain key points of legal construction of insurance policy language is a fact. Constructing a set of prescriptive principles that would guarantee the “correct” decision in every jurisdiction, and judicial uniformity in contract construction, is perhaps an appropriate goal, but fanciful. The reality is that the proposed Restatement will mandate neither California courts nor the courts of any other state to agree always with a majority of other courts, and the proposed Restatement cannot compel and likely will not even influence courts like those in California to abandon their own often very sophisticated and long-standing maxims governing insurance policy construction. That just is not going to happen, at least not in the near term.

The drafters can control, however, the overall approach they endorse to ensure that the provisions of the proposed Restatement will be viewed as internally consistent. Courts will ultimately take unexpected turns and sometimes may disagree with the prevailing view of the majority of other courts—even state supreme courts—on matters of legal construction. In light of this, the drafters should not propose rules which might validate insurer recalcitrance and should not promote exploitation by insurers of inevitably varying constructions of ambiguous policy provisions. By implicitly overlooking some permanently problematic rulings in major markets as a result of forum shopping, the proposed Restatement does not merely “restate” the law governing the legal uncertainty safe harbor, it deepens imperfections in its application.

The structure promoted by the provisions of the proposed Restatement governing the duty to defend instead should be made to be consistent with the wisdom called for elsewhere in the proposed Restatement with respect to the issue of ambiguity in the terms of liability insurance policy language. Too many provisions of the proposed Restatement that might permit an insurer to capitalize on “legal uncertainty,” particularly uncertainty created by the insurer’s own hand, are inconsistent with other proposed rules and stated principles that embody the goals of the drafters regarding judicial resolution of such ambiguities. Any unexpected, inconsistent, and idiosyncratic ruling—especially at the trial or appellate court level—should not be deemed to retroactively excuse an insurer’s failure to have defended its insured from the outset in cases involving *bona fide* ambiguity concerning the terms of the insurer’s policy. The proposed Restatement should be revised to make this point crystal clear.

In sum and taken as a whole, the proposed Restatement laudably proposes cogent principles to promote fair judicial construction of ambiguous liability insurance policy provisions. However, the proposed

Restatement frustratingly does not connect those prescriptions to the consequences it endorses when an insurer bases its refusal to defend an insured on legal uncertainty produced by the insurer's own hand.

To wit, the proposed Restatement contemplates that the duty to defend never arises in cases of legal uncertainty as to the proper construction of the insurer's contract if the insurer's construction is ultimately validated, and expressly promotes limiting the insured's remedies in most such instances if the insurer's proffered construction is ultimately rejected.

Encouraging an insurer to disclaim a defense, betting on an ultimate resolution in its favor—even one that may be contrary to the law in other jurisdictions—does not comport with the goals governing judicial construction expressed by the proposed Restatement. Legal uncertainty does not justify an insurer declining a defense prospectively and, even more emphatically, should never be deemed to retroactively excuse an insurer's declination of its duty to defend, especially if the legal uncertainty was owing to ambiguity in terms drafted by the insurer and the insurer was aware of the ambiguity when the policy was issued and took no action to resolve it.

The better reasoned view is this: *an insurer has a duty to defend its insured if there is a possibility that the insurer's duty to indemnify will arise, from tender of the insured's defense until any uncertainty concerning the insurer's duties—whether legal or factual—is resolved as provided in section 18.*

If a definitive assessment of an insurer's duty to defend is not possible, based on the absence of controlling legal authority in the jurisdiction of reference governing construction of an ambiguous term, then the insurer has a duty to defend its insured until the day that duty is excused as a matter of law.<sup>79</sup> Ambiguous insurance policy terms subject to differing and drifting judicial constructions should by definition be deemed too uncertain to excuse the duty to defend: a duty at the heart of the liability insurance contract. Such uncertainty certainly should never be used to undermine a liability insurer's duty to defend. Upon a finding of "legal uncertainty," in short, an insurer should be deemed obliged to perform its duty to defend its insured, not

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79. As summarized in *York International Corp. v. Liberty Mutual Insurance Co.*:

Although an insurer is not obligated to defend an insured "if it can be concluded as a matter of law that there is no possible factual or legal basis on which the insurer will be obligated to indemnify the insured," the duty to defend "perdures until it is determined with certainty that the policy does not provide coverage."

No. 1:10-CV-0692, 2015 WL 4162981, at \*11 (M.D. Pa. July 9, 2015) (citation omitted) (first quoting *Frontier Ins. Co. v. New York*, 662 N.E.2d 251, 253 (N.Y. 1995); and then quoting *Hugo Boss Fashions*, 252 F.3d at 620)); see also *supra* note 77.

in any way whatsoever encouraged to abandon it.

As so aptly put in *Gray v. Zurich Insurance Co.*:

[P]rovisions as to the obligation to defend are uncertain and undefined; in the light of the reasonable expectation of the insured, they require the performance of that duty. . . . [T]he nature of the obligation to defend is itself necessarily uncertain. Although insurers have often insisted that the duty arises only if the insurer is bound to indemnify the insured, this very contention creates a dilemma. . . . [T]he policy contains its own seeds of uncertainty; the insurer has held out a promise that by its very nature is ambiguous.<sup>80</sup>

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80. 419 P.2d 168, 173 (Cal. 1966) (in bank) (footnote omitted).

APPENDIX<sup>81</sup>

BLACK LETTER OF TENTATIVE DRAFT NO. 1

Section 4. Ambiguous Terms.

(1) An insurance policy term is ambiguous if there is more than one meaning to which the language of the term is reasonably susceptible when applied to the claim in question, without reference to extrinsic evidence regarding the meaning of the term.

(2) When an insurance policy term is ambiguous, the term is interpreted in favor of the party that did not supply the term, unless the other party persuades the court that this interpretation is unreasonable in light of extrinsic evidence.

(3) A standard-form insurance policy term is interpreted as if it were supplied by the insurer, without regard to which party actually supplied the term, unless the policyholder has agreed in writing to a contrary interpretative rule, in which case any term actually supplied by the policyholder will be interpreted using that contrary interpretive rule.

Section 13. Conditions Under Which the Insurer Must Defend

(1) An insurer that has issued an insurance policy that includes a duty to defend must defend any legal action brought against an insured that is based in whole or in part on any allegations that, if proven, would be covered by the policy, without regard to the merits of those allegations.

Section 18. Terminating the Duty to Defend a Claim

An insurer's duty to defend a legal action terminates only upon the occurrence of one or more of the following events:

(1) An explicit waiver by the insured of its right to a defense

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81. RESTATEMENT OF THE LAW OF LIAB. INS. (AM. LAW INST., Tentative Draft No. 1, 2016).

of the action;

(2) Final adjudication of the action;

(3) Final adjudication or dismissal of part of the action that eliminates any basis for coverage of any remaining components of the action;

(4) Settlement of the claim that fully and finally resolves the entire action;

(5) Partial settlement of the action, entered into with the consent of the insured, that eliminates any basis for coverage of any remaining components of the action;

(6) If so stated in the insurance policy, exhaustion of the applicable policy limit;

(7) A correct determination by the insurer based on undisputed facts not at issue or potentially at issue in the legal action for which the defense is sought, as permitted under § 13(3); or

(8) Final adjudication that the insurer does not have a duty to defend the action.

#### Section 19. Consequences of Breach of the Duty to Defend

(2) An insurer that breaches the duty to defend without a reasonable basis for its conduct must provide coverage for the legal action for which the defense was sought, notwithstanding any grounds for contesting coverage that the insurer could have preserved by providing a proper defense under a reservation of rights pursuant to § 15.

#### Section 21. Insurer Recoupment of the Costs of Defense

Unless otherwise stated in the insurance policy or otherwise agreed to by the insured, an insurer may not seek recoupment of defense costs from the insured, even when it is subsequently determined that the insurer did not have a duty to defend or pay defense costs.