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IN REPLY PLEASE REFER
TO FILE NO.:

February 3, 2016

Oregon State Senate
Committee on Business & Transportation

Re: Please Support SB 1590 to Protect Small Businesses

Dear Chair Beyer, Sen. Girod, Sen. Monroe, Sen. Riley, and Sen. Thomsen:

Thank you for this opportunity to express my support for SB 1590. I am a coverage attorney at the law firm of Parsons Farnell & Grein, LLP in Portland. I express this support not just on behalf of myself but also on behalf of many coverage attorneys that have worked very hard in support of SB 1590, including Michael Farnell and Steven Powers of my firm; James McDermott, Kevin Mapes, Dwain Clifford, Kyle Sturm and Nick Thede of Ball Janik, LLP; and Clinton Tapper of Taylor & Tapper. We work on the front lines of insurance disputes in Oregon and firmly believe that reform is needed to better protect small businesses and other Oregon insureds.

In the coverage group at my firm, most of our clients are small, local Oregon businesses from all parts of Oregon – from Medford to Prineville to the Portland area. They may be local contractors, developers, distributors, consulting firms, dealerships, real estate brokers, and the like. Most of our clients have been named as defendants in lawsuits and desperately need their insurance companies to protect them. They come to us because they need help getting out of harm's way.

SB 1590 is designed to address six targeted problems:

1. Duty to defend: SB 1590 will create a meaningful incentive for insurance companies to accept defense coverage when they owe a duty to defend;

2. Independent counsel: SB 1590 will clarify that defense lawyers hired by insurance companies are dedicated to protecting insureds' interests;

3. Assignment of insurance claims: SB 1590 will amend ORS 31.825 to operate as intended – i.e., to allow insureds to protect themselves from collection on a judgment by assigning their insurance claims as part of a settlement.

4. Transparency: SB 1590 will make the Insurance Division's regulatory complaint process accessible to the public;

5. Regulatory estoppel: SB 1590 will hold insurance companies to the representations that they make to regulators in the course of getting their forms approved; and

6. Tractor Fix: SB 1590 will plug the gap in UM/UIM coverage for farmers driving tractors on public roadways as they move from field to field.

Duty to Defend

Most small businesses are only one lawsuit away from going out of business – just defense costs alone can be crippling. An insured defense can be the most important benefit provided by a commercial liability policy. When an insurance company wrongfully denies defense coverage, the small business that thought it was protected suddenly finds itself fighting two battles – one with the underlying plaintiff and one with its insurance company.

Unfortunately, in Oregon, the law inadvertently encourages insurance companies to deny their duty to defend. The damages for an insurance company's breach of the duty to defend is the cost of the defense – in other words, the same dollars that the insurance company would have had to pay anyway had it timely accepted the defense. Moreover, in denying defense coverage, the insurance companies avoid undertaking the fiduciary duties to their insureds that necessarily come with any insured defense. Because a later breach of those fiduciary duties can give rise to tort damages (which can greatly exceed policy limits), this creates a legal framework that imposes greater exposure on insurance companies that

accept their defense obligations than insurance companies that blatantly breach their defense obligations. That dynamic is bad public policy and encourages insurance companies to make profit-driven business decisions that are bad for small businesses. Small businesses should not have to choose between walking away from coverage and paying coverage counsel to obtain the defense that they are properly owed and for which they already paid a premium.

Insurance companies absolutely take advantage of this dynamic. Just recently, I received a letter from an insurance company's attorney that was clearly reverse-engineered to reach a denial of the duty to defend – this attorney could only justify the denial by explicitly misstating the allegations in the complaint. Our client in that case, a local maintenance company, had to spend approximately $20,000 in legal fees to get the insurance company's attention. By way of another illustrative example, most insurance companies routinely and perfunctorily deny claims made by additional insureds. In the cases that I work, that usually involves a subcontractor's insurance company denying defense coverage for a general contractor that has been named as an additional insured on the policy. In that context, defense coverage is almost never accepted. By way of another illustrative example, we had a client come to us after he had already settled the underlying case because he could not get his insurance company to defend. My client, a local contractor, had made the tough business decision of using the money he would have had to spend on defense costs to settle the case – a case that he believed to be completely meritless. Had his insurance company provided an insured defense, however, he would have gladly fought the meritless claims. One last example, many years ago, after an insurance company had denied a developer's duty to defend based on a very aggressive and tenuous argument, the insurance company stated as part of settlement discussions that it had no problem paying for the defense; it was the fiduciary duties that it did not want. In other words, the insurance company knew it had a duty to defend but

denied to avoid undertaking fiduciary duties. These are real examples of what is happening in Oregon on the front lines of insurance disputes.

SB 1590 will change the framework of incentives to correct this problem. Under SB 1590, an insurance company that wrongfully denies the duty to defend forfeits the right to hide behind other provisions in the policy. Most importantly, that means the insurance company waives the right to contest indemnity coverage. The insurance company simply has to pay the claim, both defense and indemnity, subject to the policy limits. Moreover, small businesses can assign their claim against their insurance company as part of a settlement that will protect the small business from collection. This provides a powerful yet measured incentive for insurance companies to do the right thing. The language of SB 1590 on this issue is taken directly from a draft Restatement of Laws titled "Consequences of Breach of the Duty to Defend," currently being developed by the American Law Institute (copy appended for your convenient review). This language is not the product of special interests but rather a neutral and reputable secondary source for national trends in the law.

SB1590 will protect small businesses and other Oregon insureds that find themselves named as defendants in lawsuits by finally creating the right incentives for insurance companies to honor their duty to defend.

Independent Counsel

When insurance companies do accept defense coverage, they assign defense counsel. Under Oregon law, that defense lawyer is deemed to have two clients: the insurance company and the insured. However, small businesses and other Oregon insureds are sometimes left feeling that their assigned defense lawyer is more loyal to the insurance company client. The defense lawyer and the insurance company work together from case to case, the insurance company is paying the defense lawyers' fees, and the insurance company is the defense lawyer's source for continued work. The insured is not paying

any fees and is a one-off client that the defense lawyer may never see again. SB 1590 would resolve any doubts as to the defense lawyer's loyalty by removing the insurance company as a client of the defense lawyer. This would clarify that the defense lawyers' duty of loyalty is to the insured that he or she has been hired to defend and protect.

Assignment of Insurance Claims

Currently, ORS 31.825 expressly contemplates and allows that an insured who is a defendant may assign its insurance claim against its insurance company in exchange for protection from collection on a judgment. However, insurance companies argue that a policy's anti-assignment provision (prohibiting the assignment of "rights and duties" under the policy) trumps ORS 31.825. The problem is that anti-assignment provisions are standard in insurance policies. SB 1590 will amend ORS 31.825 to unambiguously trump anti-assignment provisions, thereby ensuring that ORS 31.825 can operate as intended.

Transparency

Currently, small businesses and other Oregon insureds can submit regulatory complaints to the Insurance Division of the Department of Consumer and Business Services ("DCBS"). However, the complaints and what comes of those complaints is currently considered confidential. SB 1590 seeks to bring transparency to the regulatory complaint process. Not only would this allow small businesses and Oregon insureds to better vet their insurance options, but this would create a natural incentive for insurance companies to avoid the kinds of practices that give rise to regulatory complaints.

Regulatory Estoppel

Currently, insurance companies must get their forms approved by DCBS for use in Oregon. In the course of that process, sometimes insurance companies answer questions and make representations about the forms. Currently, no Oregon law requires DCBS to retain the insurance companies'

submissions or representations. And nothing prevents an insurance company from representing one thing in the approval process and then applying the form differently come claim time. SB 1590 simply brings transparency to the form approval process and ensures that insurance companies cannot tell their insureds something different than what they told regulators.

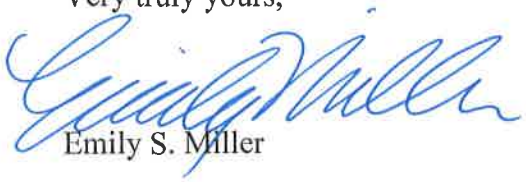
Tractor Fix

Imagine a farmer is riding a tractor on a two-lane Oregon highway to cross from one field to another and he is rear-ended by an uninsured or underinsured driver. Had the farmer been walking on the highway at the time of the accident, the farmer's auto policy would clearly provide UM/UIM coverage. However, because the farmer was riding a tractor, the auto policy excludes UM/UIM coverage. The tractor must be an insured vehicle, but auto carriers do not insure tractors. This leaves an unintended gap in UM/UIM coverage for farmers that SB 1590 will fix by excepting tractors and similar equipment from the relevant statutory exclusion.

Conclusion

SB 1590 presents targeted fixes for six discrete problems in current Oregon law. SB 1590 will protect small businesses and other Oregon insureds. Your support for SB 1590 is respectfully urged and greatly appreciated.

Very truly yours,



Emily S. Miller

ESM/czj

Restatement of the Law of Liability Insurance § 19 DD (2015)

Principles of the Law - Liability Insurance

Database updated October 2015
Restatements of the Law of Liability Insurance

Drafts

Discussion Draft (April 30, 2015) [a]

Chapter 2. Management of Potentially Insured Liability Claims

Topic 1. Defense

§ 19 Consequences of Breach of the Duty to Defend

Comment:
Reporter's Notes

(1) An insurer that breaches the duty to defend a claim loses the right to assert any control over the defense or settlement of the claim and the right to contest coverage for the claim.

(2) Damages for breach of the duty to defend include the amount of any judgment entered against the insured or the reasonable portion of a settlement entered into by or on behalf of the insured after breach, subject to the policy limits, and the reasonable defense costs incurred by or on behalf of the insured, in addition to any other damages recoverable for breach of a liability insurance contract.

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

Comment:

a. Forfeiture of defenses to a claim for coverage. The rule that an insurer that breaches the duty to defend forfeits the right to assert any control over defense or settlement is the prevailing rule. Courts have reached different conclusions regarding the survival of coverage defenses following a breach of the duty to defend. About half of the states have held that an insurer that breaches the duty to defend does not automatically forfeit its coverage defenses, but a respectable minority has held that it does. The better rule is the minority rule adopted here.

An insurer that could refuse to defend but still preserve its coverage defenses would be less willing to provide the promised defense. At least some such refusals go unchallenged, and, if the breaching insurer could preserve its coverage defenses, all that it would be required to pay in the event of a successful challenge is the amount that it should have paid at the time the insured needed the defense. Such reimbursement is a poor substitute for the expert litigation services provided when an insurer fulfills the duty to defend, especially for consumers and small businesses, but also for larger commercial entities that, in contrast to liability insurance companies, are not in the business of managing litigation. There are consequences to an inadequate or untimely defense for which an insured cannot be made whole. Moreover, the rule avoids an unfortunate incentive that is created when an insurer that defends without reserving its rights loses all of its coverage defenses while an insurer that refuses to defend preserves all those defenses. See § 15 (a defending insurer forfeits coverage defenses that are not specifically reserved). If the

insurer could deny the claim and preserve the ability to evaluate and litigate coverage later, it could be more cost effective to deny the claim in some cases, rather than undertaking the investigation required to defend under a reservation of rights.

This rule properly aligns the defense incentives of the insurer and the insured in situations in which the insurer's potential coverage defense otherwise would reduce the incentive to defend the claim. In a full-coverage case, the insurer faces all of the legal risks posed by the claim and has the appropriate incentive to fulfill the duty to defend in a manner that reflects all of those legal risks. When the insurer has a potential coverage defense, however, the insurer may not face all of the legal risks posed by the claim and, therefore, does not have the same incentive to fulfill the duty to defend despite being legally obligated to do so. See § 14, Comment *b*. The rule stated in this Section addresses this incentive problem. Because a breach of the duty to defend exposes the insurer to all of the legal risks posed by the claim, the insurer has the appropriate incentive to evaluate whether to defend the claim as if it faced all of those risks. In that sense, the forfeiture-of-coverage-defense rule is analogous to the duty to make reasonable settlement decisions, which encourages an insurer to evaluate a settlement as if the insurer would be obligated to pay the full amount of any judgment. See § 24.

The forfeiture-of-coverage-defense rule discourages insurers from attempting to convert a duty-to-defend policy into an after-the-fact defense-cost-reimbursement policy. Cf. § 15, Comment *e* (rejecting the "reject the defense" rule that would allow the insured to convert a duty-to-defend policy into an after-the-fact defense-cost-reimbursement policy). The forfeiture-of-coverage-defense rule is one of the insurance law rules that firmly underscore the principle that the promise to defend is a promise to perform, not simply a promise to decide whether to perform or to pay ordinary contract damages. By encouraging insurers to defend claims that they would not otherwise defend, the forfeiture-of-coverage-defense rule may increase the cost of liability insurance, but it provides a benefit to all insureds by increasing the certainty that insurers will defend them from liability claims.

Some have suggested that the forfeiture-of-coverage-defense rule harms insureds as a group by requiring insurers to pay claims that are not covered, thereby unjustly enriching insureds that prevail in an action for breach of the duty to defend. This suggestion is not correct. The forfeiture-of-coverage-defense rule allows an insurer to preserve its coverage defenses and refuse to pay a claim, as long as it follows the proper procedure. The proper procedure is to provide a defense subject to a reservation of rights and then, if appropriate, institute a declaratory-judgment action to terminate the duty to defend. See §§ 15 and 18. If the insurer cannot, or does not choose to, file a declaratory-judgment action, it can preserve its coverage defenses by refusing to settle the claim while continuing to provide a defense (subject to the risks attendant to breach of the duty to make reasonable settlement decisions). In that event, either the insured will exercise the right to settle the claim without the consent of the insurer, as permitted under § 25, or the case will proceed to trial. In either case, because the insurer fulfilled the duty to defend, it will be entitled to assert its coverage defenses in any subsequent breach-of-contract action and to rely upon all of the facts and circumstances (rather than the limited facts permitted under the complaint-allegation rule) in support of those defenses.

Illustrations:

1. Insured child is sued for property damage arising out of a fire allegedly started by the child at school. The complaint alleges that the child negligently caused the fire while playing with matches. An investigation by the family's homeowners insurer reveals cause for the insurer to believe that the child may have started the fire on purpose. The insurer agrees to defend the claim, reserving the right to deny coverage based on an intentional-harm exclusion in the policy. The insured requests an independent defense. The insurer refuses to provide an independent defense. The insured demands that the insurer withdraw from the defense of the claim. The insured takes over defense of the claim and settles with the claimant for a reasonable amount that is within the policy limits.The insured brings a breach-of-contract action against the insurer seeking to require the insurer to reimburse the costs of defense and pay the settlement amount. At trial in the breach-of-contract action, coverage for the claim is determined solely on the basis of whether the insurer breached the duty to defend by failing to provide an independent defense, without regard to whether the child in fact intentionally started the fire. The insurer was obligated to provide an independent defense because there were common facts at issue in the defense of the claim and the insurer's coverage defense that could

be affected by the handling of the defense. Therefore, the insurer is obligated to reimburse the insured for the costs of defense and to pay the settlement in addition to any other compensable damages.

2. Same facts as in Illustration 1, except the insurer reserved its rights to deny the claim based on an intentional-harm exclusion and provided an independent defense. The insured settled with the claimant for a reasonable amount under the procedure authorized in § 25(3). Because the insurer did not breach the duty to defend, the insurer may refuse to pay the settlement and defend a breach-of-contract action on the basis of the reserved- coverage defense.

b. Breach of the duty to defend. Actions that breach the duty to defend include a failure to defend when required, a provision of an inadequate defense, a failure to provide an independent defense when required, and a withdrawal of a defense when the duty to defend has not terminated.

c. Loss of control over defense and settlement. An insurer that breaches the duty to defend loses control over the defense and settlement of the claim. In that event, the insured, or another insurer acting on behalf of the insured, may undertake the defense and settlement of the claim and obtain reimbursement from the insurer of the reasonable costs of defense and the reasonable amount of any settlement, subject to the policy limits. If the breach of the duty to defend occurs while the insurer is defending a claim, the insured may demand that the insurer withdraw from the defense. As noted in Comment *a,* this is the prevailing rule.

d. Damages. The general topic of damages for breach of the liability insurance contract is addressed in Chapter 4. In general, an insurer is subject to liability for the foreseeable consequences of a breach of its contractual obligations. When an insurer breaches the duty to defend, those consequences include the reasonable costs of defense and, if the insured settles with the claimant, the reasonable amount of any such settlement, subject to the policy limit, in addition to any other damages recoverable for breach of a liability insurance contract. [6]

The insurer is obligated to pay the reasonable portion of an unreasonable settlement amount. An insured that is deprived of a defense may not have the means to evaluate whether a settlement is reasonable. Moreover, holding the insurer responsible to pay the reasonable portion of an unreasonable settlement will further discourage breach of the duty to defend. Holding the insurer responsible to pay the unreasonable portion, however, would insufficiently discourage the insured from entering into unreasonable settlements and could encourage collusion with plaintiffs.

Illustration:

3. Same facts as in Illustration 1, except the court also concludes in the breach-of- contract action that the settlement exceeded a reasonable settlement value by $25,000. The insurer is obligated to reimburse the insured for the costs of defense and to pay all but $25,000 of the settlement amount.

e. Consent judgments. In situations in which a formal judgment is rendered by a court against an insured following a fully litigated, insurer-funded defense, the duty to indemnify provides a clear result: the insurer must pay any covered judgment, up to the policy limits. However, if the "judgment" is reached after a process that is less than fully adversarial, whether or how much the insurer is obligated to pay is less clear. In such cases, the judgment may more appropriately be treated as a settlement, and, in that event, should be subject to the reasonableness requirements stated in this Section. Whether such judgments are treated as settlements depends on factors such as whether the insured refrained from taking actions that a reasonable defendant would have taken to avoid or reduce the extent of liability, whether the process that led to the judgment included an agreement or expectation that the claimant would not execute against the assets of the insured, and the degree to which the insured had the capacity to mount an effective defense in spite of the insurer having breached the duty to defend.

f. Liability in excess of the policy limit. A breach of the duty to defend does not obligate the insurer to indemnify the insured for amounts in excess of the policy limit. An insurer that breaches the duty to defend may become obligated to pay such amounts

only as a result of the breach of some other obligation, such as the duty to make reasonable settlement decisions or the duty of good faith and fair dealing.

g. Bad-faith breach. The principles stated in this Section address the consequences of an ordinary breach of the duty to defend. Additional damages may be available if the breach meets the standard for bad faith. [7]

h. Mandatory rules. The rule stated in subsection (3) regarding assignment is the prevailing rule. Although courts have not emphasized this point, it is possible to conclude that this rule is mandatory because cases permitting assignment regularly involve standard-form liability insurance policies that contain standard terms prohibiting assignment of rights under the policy without the insurer's consent.

Reporter's Notes

a. Forfeiture of defenses to a claim for coverage. Although the case law is less well-developed and more variable than commonly appreciated, the forfeiture rule stated in subsection (1) is a minority rule. See Stephen S. Ashley, Bad Faith Actions Liability & Damages § 4:7 (database updated September 2011) ("A minority of states have adopted the rule that if the insurer erroneously refuses to defend and the third party obtains a judgment against the insured, the insurer may not later contest coverage."). See also Flannery v. Allstate Ins. Co., 49 F. Supp. 2d 1223, 1227 (D. Colo. 1999) ("The majority of jurisdictions ... do not preclude an insurer from contesting coverage because it breached its duty to defend."). For further discussion related to the estoppel rule stated in subsection (1), see Robert H. Jerry, II, and Douglas R. Richmond, Understanding Insurance Law at 861 (4th ed. 2007):

> At first glance, it might seem that estopping the insurer to deny coverage when it unjustifiably refuses to defend puts the insurer in an impossible dilemma ... The answer is that the insurer is not on the horns of a dilemma because ... [t]here are mechanisms that enable an insurer to perform its duty to defend without giving up the right to contest coverage later.... Indeed it is the availability of these procedural alternatives that provides the best reason for estopping the insurer to deny coverage when it breaches the duty to defend.

For cases adopting the rule stated in subsection (1), see, e.g., In re Abrams & Abrams, P.A., 605 F.3d 238, 241 (4th Cir. 2010) (under North Carolina law "if an insurer improperly refuses to defend a claim, it is estopped from denying coverage and must pay any reasonable settlement ...."); Great Divide Ins. Co. v. Carpenter ex rel. Reed, 79 P.3d 599, 609-610 (Alaska 2003); Twin City Fire Ins. Co. v. City of Madison, Miss., 309 F.3d 901 (5th Cir. 2002) (applying Mississippi law and ruling on the basis of estoppel); Farmers Union Mut. Ins. Co. v. Staples, 90 P.3d 381 (Mont. 2004) ("the court should have ended the analysis and concluded that since FUMIC breached that duty, it was estopped from denying coverage and Staples was entitled to summary judgment"); Employers Ins. of Wausau v. Ehlco Liquidating Trust, 708 N.E.2d 1122, 1135 (Ill. 1999) ("Once the insurer breaches its duty to defend .... the estoppel doctrine has broad application and operates to bar the insurer from raising policy defenses to coverage, even those defenses that may have been successful had the insurer not breached its duty to defend."); Conanicut Marine Servs., Inc. v. Insurance Co. of N. Am., 511 A.2d 967, 971 (R.I. 1986) (holding that an insurer that breaches the duty to defend cannot later contest coverage); Missionaries of Company of Mary, Inc. v. Aetna Casualty & Surety Co., 230 A.2d 21, 26 (Conn. 1967) ("The defendant having, in effect, waived the opportunity which was open to it to perform its contractual duty to defend under a reservation of its right to contest the obligation to indemnify the plaintiff, reason dictates that the defendant should reimburse the plaintiff for the full amount of the obligation reasonably incurred by it."); Gray v. Zurich Ins. Co., 65 Cal. 2d 263, 280, 419 P.2d 168 (1966) ("[A]n insurer that wrongfully refuses to defend is liable on the judgment against the insured."); Liebovich v. Minn. Ins. Co., 728 N.W.2d 357, 360-361 (Wis. Ct. App. 2007); Cent. Armature Works, Inc. v. Am. Motorists Ins. Co., 520 F. Supp. 283, 289-290 (D.D.C. 1980). Cf. Capstone Bldg. Corp. v. Am. Motorists Ins. Co., 67 A.3d 961 (Conn. 2013) (limiting the earlier Missionaries rule by holding that an insurer forfeits coverage defenses only for these causes of action "contained in the complaint or fairly discernible from the demand for defense, when considered

independently" that it had a duty to defend, not for causes of action that it would not have had a duty to defend had they not been combined in the same action); Essex Ins. Co. v. Five Star Dye House, Inc., 137 P.3d 192 (Cal. 2006) (insurer forfeits coverage defenses as a consequence of a bad-faith refusal to defend); Truck Ins. Exch. v. Vanport Homes, 58 P.3d 276 (Wash. 2002) (insurer forfeits coverage defense because of bad-faith breach of the duty to defend).

For cases permitting the insurer to contest coverage notwithstanding a breach of the duty to defend, see, e.g., Employers Cas. Co. v. Block, 744 S.W.2d 940, 943-944 (Tex. 1988), overruled on other grounds by State Farm Fire & Cas. Co. v. Gandy, 925 S.W.2d 696, 714 (Tex. 1996); Sentinel Ins. Co., Ltd v. First Ins Co. of Haw., Ltd, 875 P.2d 894, 912 (Haw. 1994) (loss of coverage is too great a penalty in the absence of bad faith); Servidone Const. Corp. v. Security Ins. Co. of Hartford, 64 N.Y.2d 419, 423, 477 N.E.2d 441 (1985) (recently reaffirmed on stare decisis grounds in K2 Investment Group, LLC v. American Guarantee & Liability Ins. Co., 22 N.Y.3d 578 (2014), a decision that reversed after rehearing an earlier Court of Appeals opinion in the same case that had adopted the forfeiture-of-coverage rule apparently in ignorance of the prior *Servidone* opinion). Because an insurer who breaches the duty to defend may be bound to reasonable settlements of the action that it refused to defend, including the reasonable allocation of those settlements to covered claims, the ability to contest coverage may not in practice be as valuable as it might appear to be in theory. See H. Walter Croskey et al., California Practice Guide: Insurance Litigation 7:697 ("absent evidence that a settlement was unreasonable or the product of fraud or collusion, the parties' allocation of settlement proceeds solely to covered claims will not be set aside, even where the insured has been found liable for noncovered damages") (citing Howard v. American Nat'l Fire Ins. Co., 187 Cal. App. 4th 498, 532-533 (2004) (insurer liable for entire postjudgment settlement characterized as compensating plaintiffs for "physical injuries and sickness" even though judgment included punitive-damages award)). See also Liberty Mut. Ins. Co. v. Metzler, 586 N.E. 2d 897 (Ind. Ct. Ap. 1992) (insurer is collaterally estopped to deny coverage if underlying claim is resolved on the basis of facts bringing the result within the scope of coverage). Especially in the commercial context, insurers could protect themselves from much of the additional costs that are said to be attributable to the forfeiture-of-coverage rule by including a defense-cost-reimbursement provision in their insurance policies. Such a provision would reduce the extent to which an insurer would bear the cost of defending a claim that it is subsequently held not to have been required to defend.

b. Breach of the duty to defend. An insurer can breach its duty to defend in multiple ways. An insurer breaches simply by refusing to defend where it has a duty to do so. See, e.g., In re Abrams & Abrams, P.A., 605 F.3d 238, 241 (4th Cir. 2010) ("[I]f an insurer improperly refuses to defend a claim, it is estopped from denying coverage and must pay any reasonable settlement ...."); see also Francis C. Amendola et al., Insurer's Liability for Wrongful Failure or Refusal to Defend, 46 C.J.S. Insurance § 1641 (2012) ("When an insurance company wrongfully refuses to defend on the ground that the claim is not within policy coverage, the company is guilty of breach of contract, rendering it liable to the insured for all damages resulting to him or her because of such breach."); 14 Lee R. Russ with Thomas F. Segalla, Couch on Insurance § 202:6 (3d ed. 2011) (same). Similarly, an insurer breaches if it initially defends, but withdraws its defense before the duty to defend has terminated. See, e.g., City of Sandusky v. Coregis Ins. Co., 192 F. App'x 355, 361 (6th Cir. 2006) (insurer "breached its duty to defend by withdrawing its defense ... before a final order was entered or an appeal pursued."); Arceneaux v. Amstar Corp., 66 So. 3d 438, 450 (La. 2011) (insurer "breached its duty to defend by withdrawing its defense" before "petitions ... unambiguously exclude[d] coverage.").

An insurer also breaches if it defends, but fails to provide an adequate defense. See, e.g., Carrousel Concessions, Inc. v. Florida Ins. Guar. Ass'n, 483 So. 2d 513, 517 (Fla. Ct. App. 1986) ("If [the insured] is able to establish that the defense supplied by [the insurer] was inadequate," the insurer has breached its duty to defend and the insured could recover "all reasonable costs and attorney's fees."); Sierra Pacific Industries v. American States Ins. Co., No. 2:11-cv-00346-MCE-JFM, 2011 WL 2935878 at *6 (E.D. Cal. July 18, 2011) (denying summary judgment to the insurer in part because the insured had "alleged facts sufficient to establish that Defendant may have breached its duty to employ competent counsel and provide counsel with adequate funding, in breach of Defendant's duty to defend."). Finally, an insurer may breach its duty to defend if it fails to provide adequate independent counsel when obligated to do so. See, e.g., Great Divide Ins. Co. v. Carpenter ex rel. Reed, 79 P.3d 599, 609-610 (Alaska 2003) (holding that failure to notify the insured of his right to have independent counsel paid for by the insurer constituted a breach of the insurer's duty to defend); Travelers Indem. Co. of Ill. v. Royal Oak Enterprises, Inc., 429 F. Supp. 2d 1265, 1273 & n.32 (M.D. Fla. 2004) (finding that a claim of breach of duty to defend could survive because

"allegations that an insurer failed to provide mutually agreeable independent counsel when a conflict of interest arose during the defense of an insured are sufficient for purposes of a motion to dismiss."); Lloyd v. State Farm Mut. Auto. Ins. Co., 860 P.2d 1300, 1301 (Ariz. Ct. App. 1992) (holding "that an insurer's voluntary assumption of the duty to defend may give rise to a cause of action for derelictions in that defense even when there is no actual coverage"); BellSouth Telecommunications, Inc. v. Church & Tower of Florida, Inc., 930 So. 2d 668, 673 (Fla. Dist. Ct. App. 2006) (labeling "meritless" an insurer's attempted distinction that a case relied on by the insured "involved a failure to provide an adequate defense, rather than a refusal to provide a defense at all"); 14 Couch on Insurance § 205:27 ("An insurer who accepts a duty to defend an insured under a reservation of rights, but then performs the duty in bad faith, is no less liable than an insurer who accepts but later rejects its duty."); 2 California Ins. Law Dictionary & Desk Ref. § I14 (2011 ed.) ("inadequate or perfunctory defense is tantamount to an insurer's refusal to defend").

c. Loss of control over defense and settlement. "It appears well settled that an insurer cannot deny liability as against the insured and refuse to defend an action brought against the latter ... and at the same time insist on controlling the defense." C. T. Drechsler, Consequences of liability insurer's refusal to assume defense of action against insured upon ground that claim upon which action is based is not within coverage of policy, 49 A.L.R.2d 694 § 18 (Originally Published 1956). See, e.g., Burgett, Inc. v. American Zurich Ins. Co., 830 F. Supp. 2d 953, 965 (E.D. Cal. 2011), quoting Intergulf Devel. v. Super. Ct., 107 Cal. Rptr. 2d 162, 165 (Cal. Ct. App. 2010). See, e.g., Willcox v. American Home Assur. Co., 900 F. Supp. 850, 855 (S.D. Tex. 1995) ("[O]nce an insurer has breached its duty to defend, as in the instant case, the insured is free to proceed as he sees fit; he may engage his own counsel and either settle or litigate at his option."); MCO Environmental, Inc. v. Agricultural Excess & Surplus Ins. Co., 689 So. 2d 1114, 1116 (Fla. Dist. Ct. App. 1997) ("If an insurance company breaches its contractual duty to defend, the insured can take control of the case, settle it, and then sue the insurance company for damages it incurred in settling the action."); Krenitsky v. Ludlow Motor Co., 96 N.Y.S.2d 102, 104 (N.Y. App. Div. 1950) ("By refusing to defend, it has forfeited to the defendant the right to control its defense of the actions."). As explained by one commentator,

> An insurer cannot refuse to defend an action brought against the insured on the ground that the claim was outside the coverage of the policy and, at the same time, insist on controlling the defense. Consequently, an insurer's unjustified refusal to defend a suit against the insured relieves the insured of the contract obligation to leave the management of such suit to the insurer, and justifies the insured in assuming the defense of the action on his or her own account.

14 Lee R. Russ with Thomas F. Segalla, Couch on Insurance § 202:7 & n.67 (3d ed. 2011) (collecting cases in support of this rule). Following a breach of duty to defend, an insurer is bound by the judgment of the underlying case in terms of both liability and damages and thus cannot reopen or relitigate the underlying liability or damages once judgment has been entered or the case has settled. See, e.g., Garamendi v. Golden Eagle Ins. Co., 116 Cal. App. 4th 694 (2004); Matychak v. Security Mut. Ins. Co., 181 A.D.2d 957 (N.Y. Sup. Ct. App. Div. 1992) (holding the same for default judgments).

With respect to settlements, "[i]t appears well settled that an insurer cannot breach its contract by unjustifiably refusing to defend an action against the insured ... and at the same time take advantage of a policy provision prohibiting the insured from settling any claim except at his own cost without the consent of the insurer." Drechsler, 49 A.L.R.2d 694 at § 22[a]. See, e.g., Risely v. Interinsurance Exchange of Auto. Club, 107 Cal. Rptr. 3d 343, 350 (Cal. Ct. App. 2010) ("[w]here the insurer denies its insured a defense for covered claims, the insured may make reasonable, noncollusive settlement with the third party, without the insurer's consent."); Guillen ex rel. Guillen v. Potomac Ins. Co. of Illinois, 751 N.E.2d 104, 114 (Ill. Ct. App. 2001), aff'd as modified and remanded, 785 N.E.2d 1 (Ill. 2003) ("In cases such as this one, however, where there has been a breach of duty to defend, the insured may enter into a settlement without the insurer's approval."); Isadore Rosen & Sons, Inc. v. Sec. Mut. Ins. Co. of New York, 291 N.E.2d 380, 382 (N.Y. 1972) ("[W]here an insurer 'unjustifiably refuses to defend a suit, the insured may make a reasonable settlement or compromise of the injured party's claim, and is then entitled to reimbursements from the insurer, even though the policy purports to avoid liability for settlements made without the insurer's consent'."), quoting Matter of Empire State Sur. Co., 108 N.E. 825 (N.Y. 1915). See generally 3 Seth D. Lamden, New Appleman on Insurance Law Library Ed. § 17.07[1] (2011) ("If an insurer breaches its duty to defend, however, the insured may enter into a reasonable, non-collusive settlement without the consent of the insurer and without forfeiting coverage.")

d. Damages. An insurer that wrongfully refuses to defend "becomes liable for all damages which flow naturally from the breach," including "reasonable costs and attorney's fees that [the insured] incurred in its defense." MCO Environmental, Inc. v. Agricultural Excess & Surplus Ins. Co., 689 So. 2d 1114, 1116 (Fla. Dist. Ct. App. 1997). See, e.g., Burgett, Inc. v. American Zurich Ins. Co., 830 F. Supp. 953, 964 (E.D. Cal. 2011) ("[W]here an insurer wrongfully 'refuses to defend an action against its insured ... the insurer is liable for the total amount of fees unless the insurer produces undeniable evidence that it is not liable for all of the attorney's fees.'"); Chandler v. Doherty, 702 N.E.2d 634, 640 (Ill. Ct. App. 1998) ("When an insurance company unjustifiably refuses to defend its insured, the measure of damages is (1) the amount of the judgment against its insured up to the policy limits ... (2) expenses incurred by the insured in defending the suit; and (3) any additional damages traceable to its refusal to defend."). But, these fees and costs must be reasonable:

> Where an insured retains his or her own counsel to defend the case and it is subsequently determined that the insurer unjustifiably denies coverage, the insured is entitled to be reimbursed for reasonable attorney's fees and disbursements. What is reasonable is generally determined by the reasonable fees paid to defense counsel within the particular jurisdiction.

Lee R. Russ with Thomas F. Segalla, Couch on Insurance § 202:7 (3d ed. 2011). See, e.g., Aerojet-General Corp. v. Transport Indem. Co., 948 P.2d 909, 924 (Cal. 1997) ("[When] the insurer has breached its duty to defend ... the insurer must carry the burden of proof that [defense costs] are in fact unreasonable or unnecessary."); Conway v. Country Cas. Ins. Co., 442 N.E.2d 245, 248 (Ill. 1982) ("[A]n insurer's failure to defend, when it is under obligation to do so, makes it liable for reasonable attorney fees and the costs incurred by its insured."). For a discussion of the factors courts may take into account in considering the reasonableness of attorney's fees, see 3 Seth D. Lamden, New Appleman on Insurance Law Library Ed. § 17.07[1] (2011).

For cases requiring an insurer to pay the reasonable amount of an unreasonable settlement, see State Farm Fire & Cas. Co. v. Farmers Alliance Mut. Ins. Co., 96 P.3d 1179, 1184-1185 (N.M. 2004) (holding that "the primary insurer ... is bound by the settlement reached between" an additional insurer and the plaintiff but that in reimbursing the other insurer who settled the claim, the primary insurer was only responsible for "$250,000, out of the total $375,000 settlement, because a reasonable settlement should not have exceeded $250,000"); Copeland v. Assurance Co. of Am., 2005 WL 2487974 (W.D. Wash. 2005) ("A party whose liability insurer has acted in bad faith by denying coverage may proceed to make his own settlement with an injured plaintiff, and then seek reimbursement from the insurer. However, the insurer is only liable for the amount of the settlement that is reasonable and paid in good faith."); Zurich Ins. Co. v. Killer Music, Inc., 998 F.2d 674, 680 (9th Cir. 1993) (remanding action "for a determination of the damages attributable to a reasonable settlement"); New Hampshire Ins. Co. v. Mendocino Forest Products, Co., LLC, 2007 WL 2875683 (N.D. Cal. 2007) (interpreting *Zurich* as "stand[ing] for the proposition that an insurer is liable for a 'reasonable settlement of the claim in good faith,' but is not obligated beyond the reasonable value of the settlement"). See also Lynn Haggerty King & Heidi Loken Benas, The Duty to Defend: When Does It Exist and What Damages Are Recoverable for Its Breach?, 7 U.S.F. Mar. L.J. 245, 267 (1994) ("If the insurer can show that the agreement to settle is unreasonable, it will not be responsible for payment of the full amount.").

e. Consent judgments. See generally Douglas R. Richmond, The Consent Judgment Quandary of Insurance Law, 48 Tort Trial & Insurance Practices J. 537 (2013).

f. Liability in excess of the policy limit. "The liability of the insurer is ordinarily not increased beyond policy limits because it wrongfully refuses to defend the insured." 1 Allan D. Windt, Insurance Claims and Disputes § 4:36 & n.1 (6th ed. 2013) (collecting cases). See, e.g., State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 954 (Ariz. Ct. App. 1979) ("The general rule, however, is that such a refusal to defend in and of itself does not expose the insurance carrier to greater liability than contractually provided in the policy."); George Winchell, Inc. v. Norris, 633 P.2d 1174 (Kan. Ct. App. 1981) (finding that the insurer had not refused to defend in bad faith and the insured therefore could not recover the judgment amount in excess of the policy limits); Conway v. Country Cas. Ins. Co., 442 N.E.2d 245, 249 (Ill. 1982) ("'The mere failure to defend does not, in the absence of bad faith, render the insurer liable for that amount of the judgment in excess of the policy limits.'"), quoting

Reis v. Aetna Cas. and Sur. Co. of Illinois, 387 N.E.2d 700 (Ill. App. 1st Dist. 1978). See also 1 Irvin E. Schermer & William Schermer, Auto. Liability. Ins. § 14:3 (4th ed. 2012) ("Where ... the only wrongful act on the part of the insurer is its refusal to defend, the majority rule holds that the insurer is liable only up to its policy limits and for the insured's litigation expenses. But "an insurer who unreasonably denies its defense obligation may be found to have acted in bad faith. If bad faith is found, an insurer's liability may extend beyond its policy limits." Wolf v. League General Ins. Co., 931 P.2d 184, 188-189 (Wash. Ct. App. 1997) (remanding for a determination of bad faith). See generally 14 Lee R. Russ with Thomas F. Segalla, Couch on Insurance § 205:92 (3d ed. 2011) ("In jurisdictions adopting a good faith standard .... [w]here an insurer acts in bad faith by refusing to defend its insured, it is liable for the full amount of judgment or settlement, even if it exceeds policy limits.")

a This Discussion Draft is being circulated for discussion at the 2015 Annual Meeting of The American Law Institute. Other comments on the Draft are also welcome. As of the time of publication of this Draft, neither the Council nor the membership of the Institute has taken a position on the material contained within it; therefore, the views expressed here do not represent the position of the Institute.

6 Note that it is anticipated that the remedies Sections in Chapter 4 will state that damages for breach of a liability insurance contract will include attorney's fees. In the event that a different rule is stated, § 21(2) will be revised to include attorney's fees.

7 The topic of bad-faith breach of the liability insurance contract will be addressed in Chapter 4. An appropriate cross-reference and summary discussion will be inserted here.

REST-LIABINS § 19 DD

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