

Broadening the Insurer's Duty to Defend: How *Gray v. Zurich Insurance Co.* Transformed Liability Insurance Into Litigation Insurance

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INTRODUCTION

In the standard liability insurance policy the insurer makes two related, though distinct, promises. First, the insurer promises to indemnify the insured for all losses covered by the policy up to the policy limits. Second, the insurer promises to defend the insured should the insured be sued for any claim covered by the policy. While both obligations are tied to the scope of coverage provided by the policy, the obligations are neither coequal nor coextensive under the law. Courts often assert that the duty to defend is broader than the duty to indemnify in the sense that the insurer may be obligated to defend its insured in situations where an obligation to indemnify the insured does not and will not exist.¹

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¹ See, e.g., *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 176-79 (Cal. 1966); *Conway v. Country Casualty Ins. Co.*, 442 N.E.2d 245, 247 (Ill. 1982). See

Since both the duty to defend and the duty to indemnify are tied to questions of coverage and since the duty to defend is further tied, at least contractually, to the duty to indemnify,² this disparity between the scope of the duty to defend and the scope of the duty to indemnify is anomalous. One would not expect that a contracting party, here the insurer, would be contractually obligated to provide a defense to a claim for which the party has no contractual obligation to pay indemnity. The parties could, of course, provide otherwise contractually. They do not, however; instead, courts have done it for them. The traditional explanation for why courts have done this is timing.³

The insurer's duty to indemnify the insured is merely conditional until a judgment against the insured is rendered. At that point the duty ripens into an enforceable obligation. Indeed, the liability insurance policy will invariably preclude a direct action against the insurer until the loss has been fixed by a judgment

generally 7C JOHN A. APPLEMAN, INSURANCE LAW & PRACTICE § 4682 (Berdal ed. 1979 & Supp. 1991); ROBERT E. KEETON & ALAN A. WIDISS, INSURANCE LAW § 9.1(b) (Student ed. 1988).

² See *S. Freedman & Sons, Inc. v. Hartford Fire Ins. Co.*, 396 A.2d 195, 197 (D.C. 1978) ("The distinction between alleged and proven facts requires that the duty to defend be larger than the duty to indemnify, but there is nothing here that requires that the duty to defend be larger than the scope of the policy."); *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7, 10 (N.J. 1970) ("The covenant to defend is thus identified with the covenant to pay."); *Crown Center Redevelopment Corp. v. Occidental Fire & Casualty Co. of N.C.*, 716 S.W.2d 348, 357 (Mo. Ct. App. 1986) ("[I]f there is no contract to defend there is no duty to defend."); *All-Star Ins. Corp. v. Steel Bar, Inc.*, 324 F. Supp. 160, 163 (N.D. Ind. 1971) (finding no common law duty to defend). *But cf.* *United States v. United States Fidelity & Guar. Co.*, 601 F.2d 1136, 1141 (10th Cir. 1979); *Healy Tibbits Constr. Co. v. Foremost Ins. Co.*, 482 F. Supp. 830, 837 (N.D. Cal. 1979) (stating that if insurer wishes to protect itself from obligation to defend, exclusion must refer to both duty to indemnify *and* duty to defend); *Aetna Casualty & Sur. Co. v. Certain Underwriters*, 129 Cal. Rptr. 47, 52-53 (Ct. App. 1976) (holding that even though insurance contract is silent, court will *imply* a duty to defend).

³ See *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966); *infra* notes 37-64 and accompanying text (discussing *Gray*); see also *Fresno Economy Import Used Cars, Inc. v. United States Fidelity & Guar. Co.*, 142 Cal. Rptr. 681, 685 (Ct. App. 1977) ("[T]he duty to defend is broader than the obligation to indemnify. This results from the difficulty in determining whether the third party suit falls within the indemnification coverage before the suit is resolved."). See *generally* KEETON & WIDISS, *supra* note 1, § 9.1(b); BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 5.02 (3d ed. 1990).

against the insured.⁴ As a consequence, it is usually easy to determine if the loss is covered for purposes of indemnification because the events and circumstances that gave rise to the loss have been fixed by a judgment, which is binding on the insurer.⁵

Unlike the determination of whether the duty to indemnify attaches, which involves a retrospective analysis of a record of established facts, the determination of whether the duty to defend attaches involves a prospective analysis in the absence of such a record. The insurer must make this determination at the time the insured informs the insurer that a lawsuit has been commenced. At that time, both the insurer and the insured are most likely in the worst position to forecast, much less determine, what the facts regarding coverage will eventually be found to be.

While timing is the reason courts give for according the duty to defend a broader scope than the duty to indemnify, timing cannot completely explain, much less justify, such a result. For the result of the broadened duty to defend is that the insurer must defend against claims it has not contractually agreed to cover because of the possibility that claims the insurer *has* agreed to cover may be asserted against the insured. The fact that the parties to the contract may have to operate behind a veil of uncertainty as to a future event does not explain why the insurer should be compelled to defend claims outside coverage. Indeed, the discontinuity between the duty to defend and the duty to indemnify exists only because courts have chosen to extend the duty to defend to encompass noncovered claims due to the possibility that a covered claim may be asserted against the insured.

Courts could, no doubt, reserve a determination of whether the duty to defend attaches until the insured's liability for the loss is determined. The record would then establish whether a claim within coverage had *ever* been asserted against the insured. Based on that determination the court would adjust the insurer-insured relationship by compensating the appropriate party for either the mistaken assumption or mistaken rejection of the defense—compensation being limited to the reasonable costs of defending the action.⁶ Most courts have rejected this approach in favor of an

⁴ See KEETON & WIDISS, *supra* note 1, § 4.8(b) (discussing "no action" clauses).

⁵ The judgment binds the insurer when the insurer has assumed control of the defense. See RESTATEMENT (SECOND) OF JUDGMENTS §§ 57-58 (1982).

⁶ Some jurisdictions have adopted this approach. See, e.g., *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7 (N.J. 1970). In *Burd*, the insurer did not provide a

approach that substantially expands the insurer's obligations to provide a defense because the insurer must bear all the risks associated with uncertainty.⁷

Because the consequences of refusing to accept the defense of the insured can be quite severe,⁸ in all but the clearest cases of noncoverage insurers must accept the tender, even if only conditionally.⁹ Moreover, because the duty to defend includes the duty

defense due to a conflict of interest with its insured. The insured sought to require the insurer to pay for independent counsel. The court refused, holding that the insured would receive reimbursement if it were subsequently determined that the insurer's refusal of a defense was a breach of its contractual obligations. *Cf. Zaborac v. American Casualty Co.*, 663 F. Supp. 330 (C.D. Ill. 1987); *Bank of Commerce & Trust Co. v. National Union Fire Ins. Co.*, 651 F. Supp. 474 (N.D. Okla. 1986). These decisions are not directly on point because the policies involved did not contain an express duty to defend clause, but instead were indemnity-only policies. The policies did, however, include attorney fees as covered losses. Hence, if a claim were adjudicated to be covered, the costs of defending against that claim would be reimbursable to the insured. *Burd, Zaborac, and Bank of Commerce* illustrate that no practical impediment exists to a pure retrospective approach to determining whether the duty to defend attaches.

⁷ See 14 GEORGE J. COUCH ET AL., *COUCH ON INSURANCE* 2D § 51:52 (Rev. ed. 1982); 7C APPLEMAN, *supra* note 1, § 4683, at 42-48.

⁸ Where the insurer breaches the duty to defend by refusing to accept a valid tender, the insurer becomes responsible for the insured's litigation costs and is normally required to indemnify the insured for a policy-limits settlement of the underlying claim. See *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 536 F.2d 730 (7th Cir. 1976); *Seward v. State Farm Mut. Auto. Ins. Co.*, 392 F.2d 723 (5th Cir. 1968); *Comunale v. Traders & General Ins. Co.*, 328 P.2d 198 (Cal. 1958); *Engeldinger v. State Autom. & Casualty Underwriters*, 236 N.W.2d 596 (Minn. 1975); *Gordon v. Nationwide Mut. Ins. Co.*, 285 N.E.2d 849 (N.Y. 1972), *cert. denied*, 410 U.S. 931 (1973). See generally 7C APPLEMAN, *supra* note 1, § 4689, at 207-14. Some jurisdictions require the insurer to pay even an excess judgment. See, e.g., *Frankenmuth Mut. Ins. Co. v. Keeley*, 447 N.W.2d 691 (Mich. 1989) (holding that where there is a bad faith refusal to assume defense, it is irrelevant whether insured could have satisfied judgment). A few courts have allowed punitive damage claims in breach of duty to defend cases. See generally Milton Roberts, Annotation, *Insurer's Tort Liability for Consequential or Punitive Damages for Wrongful Failure or Refusal to Defend Insured*, 20 A.L.R.4th 23 (1983 & Supp. 1990).

⁹ An insurer may conditionally accept the defense of its insured either by a bilateral "no waiver of rights" agreement or by a unilateral "reservation of rights." A "reservation of rights" is a declaration by the insurer that it is accepting the tender of the defense conditionally. See *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 126 Cal. Rptr. 267, 272-73 (Ct. App. 1975). Although one California court has held that the mere conditional

to settle, insurers often find themselves placed in a quandary where they must effect, or at least attempt, a settlement of claims not within policy coverage.¹⁰ The net result is that the insurer ends up providing coverage for claims that neither the insurer nor the insured intended to be covered.

Such a result effectively transforms liability insurance into litigation insurance, at least with respect to the expenses of litigation.¹¹ Given the costs of litigation today, this transformation is not an insignificant development for insureds. Moreover, to the extent that the wrongful denial of defense obligations requires the insurer to provide indemnification for what would otherwise be noncovered claims, the defense obligation becomes *primes inter pares* insofar as insurance contract clauses are concerned.

This Article accepts the transformation but challenges the common justification of "timing" as inadequate. Part I traces the development of the duty to defend as a part of the general obliga-

acceptance of the defense creates a "conflict of interest between the insurer and the insured," *see* San Diego Naval Credit Union v. Cumis Ins. Soc'y, 208 Cal. Rptr. 494 (Ct. App. 1984), that position is not generally accepted. *See* Foremost Ins. Co. v. Wilks, 253 Cal. Rptr. 596 (Ct. App. 1988). *See generally* KEETON & WIDISS, *supra* note 1, § 6.7(a)(2)-(3).

¹⁰ *See* Travelers Ins. Co. v. Leshner, 231 Cal. Rptr. 791, 796 (Ct. App. 1986) (finding that insurer's duty to defend includes duty to negotiate and evaluate settlement offers; duty is not affected by existence of coverage dispute); *see also* Luria Bros. & Co. v. Alliance Assurance Co., 780 F.2d 1082, 1091 (2d Cir. 1986); Maneikis v. St. Paul Ins. Co. of Ill., 655 F.2d 818, 827 (7th Cir. 1981) (applying Illinois law); 7C APPLEMAN, *supra* note 1, §§ 4681-715 (discussing duty to defend *and* settle). *But cf.* Burroughs Wellcome Co. v. Commercial Union Ins. Co., 713 F. Supp. 694, 698-99 (S.D.N.Y. 1989) (holding that settlement cost is equated with indemnification; no duty to reimburse insured who settled noncovered claims); Underwriters at Lloyds v. Denali Seafoods, Inc., 729 F. Supp. 721, 725 (W.D. Wash. 1989) (same). The duty to settle may also arise from other contractual obligations contained in the policy, such as the implied covenant of good faith and fair dealing. *See* KEETON & WIDISS, *supra* note 1, § 7.8(a), at 877. Also, the policy itself may contain an *express* obligation to settle. *Id.* at 875-76.

¹¹ *See* Seaboard Sur. Co. v. Gillette Co., 476 N.E.2d 272, 275 (N.Y. 1984) ("Though policy coverage is often denominated a 'liability insurance,' where the insurer has made promises to defend 'it is clear that [the coverage] is, in fact, 'litigation insurance' as well.'") (alteration in original) (quoting International Paper Co. v. Continental Casualty Co., 320 N.E.2d 619, 621 (N.Y. 1974)); *see also* Solo Cup Co. v. Federal Ins. Co., 619 F.2d 1178, 1185 (7th Cir.) (stating that one of the basic purposes of the defense clause in a liability insurance policy is protection of the insured from the expenses of litigation), *cert. denied*, 449 U.S. 1033 (1980).

tions that the insurer assumes under the liability policy. Part II examines the extension of the duty to defend to encompass situations where the covered claim is only potential. Part III examines the justifications for this expansion of the duty to defend. This part finds that the standard justification of timing is inadequate because timing offers no independent substantiation for accelerating the insurer's duty to defend except uncertainty whether a covered claim will be asserted against the insured. Also, the standard justification offers no reason for resolving this uncertainty against the insurer. This Article suggests that the potentiality test is justified on the ground that it forces insurers to internalize the costs and benefits associated with acceptance or rejection of the duty to defend. This new justification harmonizes judicial expansion of the duty to defend with approaches used in other areas where conflicts arise between insurer and insured.

I. THE ORIGIN OF THE INSURER'S DUTY TO DEFEND

The development of the present duty of insurers to defend their insureds cannot be described exactly, especially with respect to a necessary cause-effect relationship. Correlations do not establish causation, yet several interesting signposts evidence a profound sea of change in the insurer-insured relationship that was accomplished by extension and expansion of the duty to defend.

When liability policies came into use around the beginning of the twentieth century, they were commonly described as indemnity policies. Insurers agreed to indemnify insureds who satisfied claims established against them arising out of adjudications of liability toward third parties.¹² A common condition to payment under such policies was that the insured had actually satisfied the judgment. Hence, the policies were true indemnification poli-

¹² During this time period, insurance policies provided indemnification against losses from common law or statutory liability. A distinction was drawn between indemnification against "liability for damages" and indemnification against "loss from liability for damages." Under the latter, no liability arose until the insured satisfied the underlying claim and the claim had been adjudicated by a court of competent jurisdiction. *See* *Gilbert v. Wiman*, 1 N.Y. 550 (1848); *Cushman v. Carbondale Fuel Co.*, 98 N.W. 509 (Iowa 1904); *Finley v. United States Casualty Co.*, 83 S.W. 2 (Tenn. 1904); *Connolly v. Bolster*, 72 N.E. 981 (Mass. 1905); *Tulare County Power Co. v. Pacific Sur. Co.*, 185 P. 399 (Cal. Ct. App. 1919).

cies.¹³ Moreover, to protect the insurer's financial self-interest, these indemnity policies frequently contained a provision that allowed the insurer the right to assume, *for its benefit*, control of the defense of the underlying claim.¹⁴ Initially, the insurer had no affirmative duty to accept the defense. By the 1930's, however, the insurer's *power* to defend had been transformed into a *duty* to defend.

What led to this transformation cannot be stated with certainty. Some insurers contracted expressly to assume the defense of any claim within coverage asserted against the insured. Where the insurer did not assume this contractual obligation, several courts found an obligation nonetheless.¹⁵ Yet this limited inroad was small at first. Reimbursement was the majority rule. And the fact that some insurers began to bargain for the contractual obligation to defend does not inform us why they were encouraged or prompted to do so.

The first significant inroad on the insurer's preferred position was occasioned by the abridgement of the requirement that the insured actually *pay* the judgment entered against her as a condi-

¹³ One reason for the initial framing of insurance as for indemnity only was to avoid the claim that insurance for tort liability frustrated public policy goals of deterrence and retribution. See Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313 (1990). It was not until the beginning of this century that liability insurance policies were consistently recognized as lawful contracts. *Id.* at 314. It was likewise during this time period that courts began to examine closely the duties and obligations of the insurer under the contract.

¹⁴ See, e.g., *Davison v. Maryland Casualty Co.*, 83 N.E. 407 (Mass. 1908):

The [policy] provides that the company will "defend against such proceedings in the name and on behalf of the assured, or settle the same at its own cost." Doubtless the defendant must pay all expenses of the defense of the action against the insured, whether the words "at its own cost" qualify the verb "defend" or are to be limited to the words "settle the same." But this article is not put in to add to the indemnity to which the plaintiffs are entitled. It is manifestly inserted to describe the terms on which the defense of the action which is given to the company for its own benefit by articles 2 and 3 is to be conducted.

Id. at 407-08 (citation omitted). If the insurer exercised its power to control the defense, it was obligated to pay the expenses itself; the insurer could not protect itself and expect its insured to pay litigation costs.

¹⁵ See *Patterson v. Adan*, 138 N.W. 281 (Minn. 1912); *Sanders v. Frankfort Ins. Co.*, 57 A. 655 (N.H. 1904); *Davies v. Maryland Casualty Co.*, 154 P. 1116 (Wash. 1916).

tion to securing indemnification from the insurer.¹⁶ This movement was propelled by financial responsibility legislation, which sought to make insurance proceeds more accessible to victims of automobile accidents who sued insured defendants.¹⁷ Although it is frequently urged that each line and type of insurance should be considered as *sui generis*, cross-pollination is often encountered. Rules adopted in and for automobile liability insurance disputes could have influenced courts in developing the general rules to be applied in all liability insurance disputes.

A further inroad occurred when courts began to hold that an insurer would be bound by a judgment rendered in its absence where the insurer had notice of the action and the power and opportunity to control the defense of the action.¹⁸ This development was an extension of an earlier rule that had allowed the *insured* to assume control of the defense, notwithstanding a provision in the policy vesting management and control of the defense in the insurer, where the insurer refused to assume control.¹⁹ Under the earlier rule, the nondefending insurer was not barred from litigating coverage when the insured commenced an action for indemnification.²⁰ Under the revised rule, however, the insurer was barred from relitigating facts established in the underlying action. If those facts established coverage, and if the contractual duty to defend attached, the insurer was bound by that coverage determination with respect to the duty to indemnify.²¹

Once these inroads became established, they significantly altered the insurer-insured relationship. While in theory the insurer had the power to assume control of the defense, rather

¹⁶ See *Schambs v. Fidelity & Casualty Co.*, 259 F. 55 (6th Cir. 1919) (finding policy language ambiguous regarding whether payment was condition precedent; construing language against position of insurer); *Pickering v. Hartsock*, 287 S.W. 819 (Mo. Ct. App. 1926) (same); see also *Cormier v. Hudson*, 187 N.E. 625, 627 (Mass. 1933) (citing relevant cases).

¹⁷ See *Cormier v. Hudson*, 187 N.E. 625 (Mass. 1933); *Turk v. Goldberg*, 109 A. 732 (N.J. 1920).

¹⁸ See *Lamb v. Belt Casualty Co.*, 40 P.2d 311, 314 (Cal. Ct. App. 1935).

¹⁹ *St. Louis Dressed Beef & Provision Co. v. Maryland Casualty Co.*, 201 U.S. 173 (1906).

²⁰ *Id.* at 182-83.

²¹ This principle has now been extended to situations where the insured settles a claim with a third party after the insurer wrongfully refuses to defend. See *Luria Bros. & Co. v. Alliance Assurance Co.*, 780 F.2d 1082, 1091 (2d Cir. 1986); *infra* note 33.

than a duty to do so, in fact the consequences of not assuming control were so great that choice was illusory. The insurer could no longer insulate itself from a call on the indemnification provision of the policy by first insisting that the insured satisfy the claim. Thus, insurers could not hide behind judgment-proof insureds. The benefit of liability insurance was transformed from indemnification against actual out-of-pocket loss to indemnification against liability. More importantly, the insurer who refused to accept a proper tender of the defense by its insured lost the opportunity to litigate coverage issues. Control not just of the defense of the underlying claim but of the coverage issue itself was thus transferred from insurer to insured where the former refused to defend the latter.

These developing legal rules may have forced insurers to assume the duty to defend, as a practical matter, to protect their financial self-interest. It is not surprising that contract language followed practical reality and obligated the insurer to defend claims within coverage.²² The change in policy language repre-

²² It is perhaps illustrative of how far the law has moved on this issue that a court could *now* hold that an insurance contract provision that specifically limited the obligation to indemnify to situations where the insured *paid* the loss was unenforceable. See *Saunders v. Austin W. Fishing Corp.*, 224 N.E.2d 215 (Mass. 1967) (applying state statute invalidating policy provision that made payment by insured condition precedent to duty to indemnify). *But cf.* *Branning v. CNA Ins. Cos.*, 729 F. Supp. 728, 733 (W.D. Wash. 1989) (holding that while theoretically possible for insurer to include cost of defense within its liability limits, such contractual language must be clearly and unambiguously stated to be given effect). While single promise indemnification policies can be enforced, see *Continental Oil Co. v. Bonanza Corp.*, 677 F.2d 455, 459 (5th Cir. 1982); *Botany Bay Marina, Inc. v. Great American Ins. Co.*, 760 F. Supp. 88 (D.S.C. 1991), the importance of the defense obligation is such that courts have rigorously construed single promise indemnity policies to provide for payment of defense costs where the insured has a reasonable expectation that defense litigation costs will be paid by the insurer as they are incurred. *Cf.* *Okada v. MGIC Indem. Corp.*, 823 F.2d 276 (9th Cir. 1986); *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460 (W.D. Pa. 1986). *But see* *Zaborac v. American Casualty Co.*, 663 F. Supp. 330 (C.D. Ill. 1987); *supra* note 6 (discussing *Zaborac*). The court in *Okada* emphasized that the policy language obligating the insurer to cover liability for damages created a reasonable expectation that litigation costs would be paid as incurred. The court noted that if it were ultimately determined that there was no coverage, the insurer would be entitled to reimbursement. *Okada*, 823 F.2d at 281-82. *Okada*, *Little*, and *Zaborac* do not directly raise the duty to defend issue because they involved Directors and Officers liability policies, which cover legal expenses as a loss item. See

sented no real concession by insurers to insureds, save that it correctly read the handwriting on the wall. The change did, however, move the debate away from the question of *whether* there was a duty to defend—this was now acknowledged—toward the determination of the scope of that duty.

II. THE SOURCE AND SCOPE OF THE DUTY TO DEFEND

A. Original Themes

Although the duty to defend arises from contract,²³ the judicial delineation of the scope of the duty suggests that the duty is based primarily on public policy oriented legal norms that courts develop to regulate the insurer-insured relationship, rather than the private rules expressed in the contract entered into by the parties.²⁴ This extra-contractual source of the rules governing the duty to defend can be seen as we trace the judicial creation of the boundaries of the duty to defend.

As noted previously, the duty to defend, as a matter of private contract law between the parties, is defined with reference to the duty to indemnify. Moreover, since the insurance policy is

Joseph F. Johnston, Jr., *Corporate Indemnification and Liability Insurance for Directors and Officers*, 33 *BUS. LAW.* 1993, 2016, 2023 (1978). Allowing an insurer to withhold payment of defense litigation costs until coverage is decided effectively collapses indemnification and defense into a single obligation. See generally Julie J. Bisceglia, Comment, *Practical Aspects of Directors' and Officers' Liability Insurance—Allocating and Advancing Legal Fees and the Duty to Defend*, 32 *UCLA L. REV.* 690 (1985). The reluctance of some courts to allow this, even in the face of policy language allowing the insurer to do so, evidences the importance that the law now attaches to the insurer's defense obligation.

²³ See *Carrousel Concessions, Inc. v. Florida Ins. Guar. Ass'n*, 483 So. 2d 513, 516 (Fla. Dist. Ct. App. 1986); *Schiebout v. Citizens Ins. Co. of Am.*, 366 N.W.2d 45, 49 (Mich. Ct. App. 1985); *Gross v. Lloyds of London Ins. Co.*, 358 N.W.2d 266, 270 (Wis. 1984); cf. *National Grange Mut. Ins. Co. v. Continental Casualty Ins. Co.*, 650 F. Supp. 1404 (S.D.N.Y. 1986) (holding that EIL insurer was not obligated to defend insured in Superfund litigation where insurance contract did not expressly obligate insurer to do so); *supra* note 2 (discussing duty to defend).

²⁴ See generally Robert E. Keeton, *Insurance Law Rights at Variance With Policy Provisions*, 83 *HARV. L. REV.* 961 (1970) [hereafter *Rights at Variance I*]; Robert E. Keeton, *Insurance Law Rights at Variance With Policy Provisions: Part Two*, 83 *HARV. L. REV.* 1281 (1970) (discussing development between 1945 and mid-1960's of body of insurance law that rested less on policy provisions and more, if not entirely, on judicially declared rights of the insured).

designed and intended to effect the transfer between insured and insurer of a particular risk—here, loss due to liability to a third party—it is not surprising that courts first defined the scope of the duty to defend in terms of the claim pleaded against the insured in the underlying action.²⁵ Under this approach the claimant enjoyed the power to determine whether the insurer would have to provide the insured defendant with a defense under the policy. The claim alleged against the insured by the claimant determined the insurer's obligation to defend, if any, because the language of the complaint was compared with the language of the policy to determine if the claim was within the coverage provided the insured.

Initially, this formalistic approach enjoyed wide support. Some cases even suggested that the test was exclusionary: that no duty to defend existed where the complaint stated a claim outside coverage or within an exclusion to coverage, but the insurer was aware of facts that brought the claim within coverage.²⁶ However, cases suggesting that the pleadings test was the exclusive method for determining whether the duty to defend existed did

²⁵ See, e.g., *Lee v. Aetna Casualty & Sur. Co.*, 178 F.2d 750 (2d Cir. 1949) (Hand, C.J.); 7C APPLEMAN, *supra* note 1, § 4683. Appleman notes as follows:

An insurer's duty to defend an action against the insured is measured, in the first instance, by the allegations in the plaintiff's pleadings, and if such pleadings state facts bringing the injury within the coverage of the policy, the insurer must defend, irrespective of the insured's ultimate liability to the plaintiff.

Id. at 42.

²⁶ See C.T. Dreschler, Annotation, *Allegations in Third Person's Action Against Insured As Determining Liability Insurer's Duty to Defend*, 50 A.L.R.2d 458, 497-500 (1956) (discussing relevant cases). This position has been urged by some commentators. See 7C APPLEMAN, *supra* note 1, § 4683:

[M]odern rules of pleading and practice focus on the facts of the case rather than on the theory of recovery stated in the complaint, and where the insurer is aware of facts, not in the pleadings, which clearly disclose an absence of coverage, it can refuse to defend or clarify its obligation by means of a declaratory judgment action. If it refuses to defend, it does so at its peril, but it should not be required to defend a case in which it has no economic interest.

Id. at 53 (footnote omitted); see also *Southbend Escan Corp. v. Federal Ins. Co.*, 647 F. Supp. 962, 967 (N.D. Ind. 1986) (holding that the insurance company can refuse to defend if the underlying factual basis for the complaint, if proved, would not result in liability under the insurance policy).

so by way of dicta, not holding.²⁷

The question also arose whether the insurer's knowledge that the claim was, in actuality, *not* covered could trump the fact that the claimant had pleaded a claim within coverage against the insured. Courts, however, resisted excusing an insurer from its duty to defend based on the insurer's knowledge of facts that diverged from those alleged in the pleading.²⁸ In fact, courts turned the knowledge test around 180 degrees so that the test operated as a one-way ratchet. Thus, the insurer's knowledge would bring a claim into coverage even though the pleading would not, but the insurer's knowledge would not excuse a duty to defend that had otherwise been triggered by the pleading.²⁹ For the insurer to escape its duty to defend where the pleading contained a claim within coverage required a judicial determina-

²⁷ Some modern cases suggest this view, but they are a definite minority. See OSTRAGER & NEWMAN, *supra* note 3, § 5.01, at 101 (discussing relevant cases).

²⁸ See *Green Bus Lines, Inc. v. Consolidated Mut. Ins. Co.*, 426 N.Y.S.2d 981, 987 (App. Div. 1980). See generally David S. Garbett, Comment, *The Duty to Defend Clause in a Liability Insurance Policy: Should the Exclusive Pleading Test Be Replaced?*, 36 U. MIAMI L. REV. 235 (1982).

²⁹ See *Waste Management of Carolinas, Inc. v. Peerless Ins. Co.*, 340 S.E.2d 374 (N.C. 1986); *City of Willoughby Hills v. Cincinnati Ins. Co.*, 459 N.E.2d 555, 558 (Ohio 1984) (stating that extrinsic evidence can only be used to establish coverage, not negate it); see also *Afcan v. Mutual Fire, Marine & Inland Ins. Co.*, 595 P.2d 638 (Alaska 1979); *Flori v. Allstate Ins. Co.*, 388 A.2d 25 (R.I. 1978); *Colony Ins. Co. v. H.R.K. Inc.*, 728 S.W.2d 848 (Tex. Ct. App. 1987). Compare *State Farm Mut. Auto. Ins. v. Flynt*, 95 Cal. Rptr. 296 (Ct. App. 1971) (holding that insurer may bring declaratory relief action to terminate duty to defend when investigation indicates no actual coverage) with *CNA Casualty of Cal. v. Seaboard Sur. Co.*, 222 Cal. Rptr. 276 (Ct. App. 1986) (stating that pleadings control even when insurer has independent knowledge claim is not covered).

This knowledge test is occasionally identified as an independent trigger of the insurer's duty to defend. See ROBERT H. JERRY, II, *UNDERSTANDING INSURANCE LAW* § 111[2], at 564 (1987). Most decisions applying the knowledge test were rendered after the pleadings test had been rejected as a test of exclusion. The knowledge test avoids the difficulties that strict, literal application of the pleadings test would generate, given the notice function of modern pleading. Unintended errors that accompanied the drafting of the third party action, errors that were both known to be so by the insurer and that, if corrected, would have triggered coverage under the pleadings test, may be disregarded so that the spirit of the pleadings test may be realized. Under the potentiality test, if the insurer knows of facts that could trigger coverage, the test is satisfied and the duty to defend attaches.

tion that no coverage existed³⁰ or a conclusive judicial determination that would estop the insured from claiming coverage.³¹

Language in cases stating that the pleadings test was exclusive and would allow the insurer to avoid the duty to defend even where the insurer was aware of facts bringing the actual claim within coverage provided, in reality, little comfort for insurers. Pleadings are malleable. The failure of a complaint to raise the insurer's duty to defend did not mean that the insurer was immune forever from any obligation to defend. The pleadings could be read liberally or might be amended, and if by liberal reading or amendment the pleadings stated a claim within coverage, the duty to defend existed.³² Thus, an insurer who refused the tender did so at the risk that the determination might ultimately be made that the loss suffered by the claimant was within coverage and had been set forth in the claimant's pleadings. In such circumstances the insurer would be bound to indemnify the insured³³ and would be obligated to reimburse the insured for

³⁰ The insurer's burden is heavy. The insurer is obligated to show that there is no possibility of coverage under any potential coverage in the policy. *See, e.g., Country Mutual Ins. Co. v. Murray*, 239 N.E.2d 498, 505 (Ill. App. Ct. 1968) (holding that unless complaint alleges facts which, if proved true, would exclude coverage, potentiality of coverage is present); *Ogden Corp. v. Travelers Indem. Co.*, 681 F. Supp. 169, 173 (S.D.N.Y. 1988) (stating that to escape duty to defend insurer must show that claims in complaint are solely and entirely within policy exclusions and that allegations *in toto* are subject to no other interpretation).

³¹ *See Casey v. Northwestern Sec. Ins. Co.*, 491 P.2d 208 (Or. 1971) (finding that insured's noncoverage had been conclusively established by his criminal conviction for battery, which established that injury was intentionally inflicted and beyond coverage contemplated by policy). *See generally* W.E. Shipley, Annotation, *Conviction or Acquittal as Evidence of the Facts on Which it Was Based in Civil Action*, 18 A.L.R.2d 1287 (1951).

³² *See Ritchie v. Anchor Casualty Co.*, 286 P.2d 1000, 1003-04 (Cal. Ct. App. 1955); *see also Ruder & Finn, Inc. v. Seaboard Sur. Co.*, 422 N.E.2d 518 (N.Y. 1981):

[A] policy protects against poorly or incompletely pleaded cases as well as those artfully drafted. Thus the question is not whether the complaint can withstand a motion to dismiss for failure to state a cause of action. Nor is the insured's ultimate liability a consideration. If, liberally construed, the claim is within the embrace of the policy, the insurer must come forward to defend its insured no matter how groundless, false or baseless the suit may be.

Id. at 521.

³³ Initially, the insurer who had rejected the tender was allowed to

defense costs, at least from the date the claim now identified as within policy coverage was first deemed to have been pleaded.³⁴

Moreover, where the insurer was aware of facts indicating that the claim was within coverage—facts not pleaded explicitly by the claimant—it became exceedingly risky for the insurer to reject a tender. Facts known to the insurer could be expected ultimately to become known, or be deemed known, to both the insured and the claimant.³⁵ Also, the insurer who refused a tender in the

litigate the issue of its duty to defend. *See supra* notes 12-21 and accompanying text. Later cases required the insurer to first reserve its right to contest coverage. It should be noted that many disputes involve the question whether the insurer must fund the settlement negotiated by the insured with the claimant after the insurer backed out of the case. The judicial view is that an insurer who wrongfully rejects the tender should not be in a better position than an insurer who unconditionally accepts the tender. *See Thornton v. Paul*, 384 N.E.2d 335, 340 (Ill. 1978) (holding that a “major effect of the insurer’s wrongful failure to defend is to estop the insurer from later raising policy defenses or noncoverage in a subsequent action by the insured or by a judgment creditor in garnishment”). The true issue is whether the insurer who wrongfully rejects should be in a worse position than an insurer who conditionally accepts the tender under a “reservation of rights.” *See Miller v. Elite Ins. Co.*, 161 Cal. Rptr. 322, 330-31 (Ct. App. 1980); *St. Paul Fire & Marine Ins. Co. v. Vigilant Ins. Co.*, 919 F.2d 235, 240-41 (4th Cir. 1990). *See generally* 7C APPLEMAN, *supra* note 1, § 4692, at 297. The decisions often speak in terms of waiver or estoppel as justifying this rule. The scope of the waiver or estoppel doctrine is, however, not clear. Some courts limit the doctrine to policy defenses available to the insurer, such as untimely notice and breach of warranty. Other courts extend the doctrine to preclude the insurer from invoking policy exclusions from coverage. *See W.C. Craig III, Annotation, Doctrine of Estoppel or Waiver as Available to Bring Within Coverage of Insurance Policy Risks Not Covered By Its Terms or Expressly Excluded Therefrom*, 1 A.L.R.3d 1139 (1965).

³⁴ *Fireman’s Fund Ins. Co. v. Chasson*, 24 Cal. Rptr. 726, 729-30 (Ct. App. 1962); *see also Sucrest Corp. v. Fisher Governor Co.*, 371 N.Y.S.2d 927, 934 (Sup. Ct. 1975) (finding insurer’s duty to defend disclosed by insured’s third party complaint).

³⁵ Several modern decisions suggest that an insurer has an affirmative duty to disclose facts evidencing coverage to its insured. *See, e.g., Davis v. State Farm Ins. Co.*, 262 Cal. Rptr. 595 (Ct. App. 1989) (decertified by Cal. Supreme Court per CAL. RULES OF COURT Rule 976 on Dec. 14, 1989) (holding that failure of insurer to disclose possibility of coverage when it denied claim operated to toll statute of limitation). Several decisions state that the insurer owes a fiduciary duty toward its insured, but the statement is always hedged with qualifications. *See, e.g., Rawlings v. Apodaca*, 726 P.2d 565, 571 (Ariz. 1986) (“[W]e do not go so far as to hold the insurer is a fiduciary”); *Gibson v. Governmental Employees Ins. Co.*, 208 Cal. Rptr.

teeth of facts known to it that evidenced the claim was covered would be hard pressed to claim prejudice if thereafter, in the insurer's absence, the litigation took a largely foreseeable turn that resulted in the accentuating of covered claims and the downgrading or disavowal of noncovered claims.³⁶

*Gray v. Zurich Insurance Co.*³⁷ is often identified as the seminal case that encouraged movement away from the pleadings test as the measure of the insurer's duty to defend.³⁸ In fact, however, many decisions before *Gray* expressed disenchantment with the pleadings test and did not follow it as a test of exclusion. For example, in *Firco, Inc. v. Fireman's Fund Insurance Co.*,³⁹ the insured was sued for "maliciously" and "wantonly" cutting down and removing a large number of trees. The court observed that the claim as pleaded fell within the exclusion for losses intentionally caused by the insured. Nonetheless, the court held that the insurer was not excused from the duty to defend. The court

511, 517 (Ct. App. 1985) (stating that fiduciary duty of insurer "is governed by the terms of the insurance contract"); *State Farm Fire & Casualty Co. v. Superior Court*, 265 Cal. Rptr. 372, 374 (Ct. App. 1989) (finding that relationship between insurer and insured is *akin* to fiduciary relationship, but insurer does not owe total devotion that is hallmark of true fiduciary). See generally William T. Barker et al., *Is an Insurer a Fiduciary to Its Insureds?*, 25 TORT & INS. L.J. 1 (1989) (criticizing language in case law that suggests a fiduciary duty exists).

³⁶ In the face of the insurer's rejection of the tender, the litigation strategy of the insured would probably be treated as beyond reproach. The insurer's conduct would likely be deemed a unilateral, intentional relinquishment of its right to conduct the defense and thus constitute a waiver of its right to claim it had been harmed by the insured's *reasonable* conduct of the defense. What passes for a waiver in the field of insurance law, however, would not necessarily pass muster in other legal fields, such as constitutional law. See KEETON & WIDISS, *supra* note 1, §§ 6.5(g), at 663, 6.9(b), at 725.

³⁷ 419 P.2d 168 (Cal. 1966). *Gray* involved a commonplace fact pattern. The insured had been involved in an automobile accident that grew into a post-collision altercation between the insured and the driver of the other vehicle. The driver sued the insured for the intentional tort of assault. While intentional torts are normally excluded from coverage, negligent conduct is not. The insured asserted in his answer the defense of self-defense. Since negligent self-defense was a potentially covered claim, the court found that the insurer should have accepted the defense of the action on tender by the insured.

³⁸ See OSTRAGER & NEWMAN, *supra* note 3, § 5.01, at 114; 1A ROWLAND H. LONG, *THE LAW OF LIABILITY INSURANCE* § 5.07, at 5-64 (1991).

³⁹ 343 P.2d 311 (Cal. Ct. App. 1959).

noted that it might turn out that the trees were *unintentionally* removed, which would constitute a claim within coverage:

We have presented to us, therefore, an action based upon a claim that may or may not be covered by the policy. In such a situation the insurer is obligated to undertake the defense of the action and to continue such defense at least until it appears that the claim is not covered by the policy. If and when that becomes certain the insurer may turn back the defense.⁴⁰

Firco clearly advanced the "potentiality" test that the California Supreme Court would embrace in *Gray v. Zurich Insurance Co.*⁴¹ Nor was the potentiality test a California invention; other jurisdictions recognized that the duty to defend could be based on as yet unasserted claims.⁴² The decision in *Gray* from a nationally prominent court, however, provided the impetus to widespread adoption of the potentiality test and the consequent extension of the insurer's duty to defend.⁴³

Gray v. Zurich Insurance Co. profoundly affected the scope of the

⁴⁰ *Id.* at 313. How such certainty was achieved and the extent to which the insurer could use its control of the litigation to create the certainty of noncoverage were not addressed. See *infra* note 72 (discussing groundless but covered claims).

⁴¹ At least two other California cases advanced the potentiality test prior to *Gray*. See *Columbia S. Chem. Corp. v. Manufacturers & Wholesalers Indem. Exch.*, 11 Cal. Rptr. 762 (Ct. App. 1961); *Campidonica v. Transport Indem. Co.*, 31 Cal. Rptr. 735 (Ct. App. 1963). Both *Columbia* and *Campidonica* adopted the potentiality test to determine whether an insurer's duty to defend existed. Some other courts came close to the same result under the pleadings test by a pliant construction of the pleadings. See *Ritchie v. Anchor Casualty Co.*, 286 P.2d 1000, 1003-04 (Cal. Ct. App. 1955).

⁴² See, e.g., *Sims v. Illinois Nat'l Casualty Co.*, 193 N.E.2d 123 (Ill. App. Ct. 1963) (ruling that duty to defend attached where allegations stated claim "potentially" within coverage); *Crum v. Anchor Casualty Co.*, 119 N.W.2d 703 (Minn. 1963) (holding that insurer must defend where true facts would establish a potential liability on the part of the insured that is not excluded from coverage under the policy).

⁴³ The potentiality test, as developed in *Gray*, has received general acceptance outside California. See 7C APPLEMAN, *supra* note 1, § 4684.01, at 98-102 (discussing relevant cases). A number of courts have been willing to accept the expansion of the duty to defend accomplished by the use of the doctrine of reasonable expectations, discussed *infra* at note 44. See, e.g., *Raska v. Farm Bureau Mut. Ins. Co.*, 314 N.W.2d 440 (Mich. 1982); *Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co.*, 366 N.W. 2d 271, 278 (Minn. 1985). See generally OSTRAGER & NEWMAN, *supra* note 3, § 5.01. A number of jurisdictions still adhere to the pleadings test. See, e.g., *Eastern Shore Fin. Resources, Ltd. v. Donegal Mut. Ins. Co.*, 581 A.2d 452, 458-61 (Md. Ct.

insurer's duty to defend by its controlling determination that the pleadings test was a test of inclusion only, not one of exclusion, and by its recognition of both the "reasonable expectations" doctrine⁴⁴ and the potentiality test as independent, additional bases on which the insurer's duty to defend could be predicated. The reasonable expectations doctrine maintains adherence to contract rules since the duty to defend is kept within the four corners of the insurance contract. Coverage is simply construed broadly to encompass the claim asserted. The potentiality test adopted in *Gray*, however, is an extra-contractual theory because it extends the duty to defend to *asserted* claims *outside* coverage based on the prospect that *unasserted* claims *within* coverage may be brought against the insured.⁴⁵

B. *The Rationale of Gray*

Like the courts in cases before *Gray* that adopted the potentiality test, the *Gray* court based the test largely on the malleability of

Spec. App. 1990); *Heyden Newport Chem. Corp. v. Southern Gen. Ins. Co.*, 387 S.W.2d 22, 24-25 (Tex. 1965).

⁴⁴ The doctrine of reasonable expectations holds that the insurance contract should be construed to honor the reasonable expectations of the insured as to the scope of coverage. See KEETON & WIDISS, *supra* note 1, § 6.3; see also Mark C. Rahdert, *Reasonable Expectations Reconsidered*, 18 CONN. L. REV. 323, 324 (1986) (noting that the "doctrine of reasonable expectations seems to have come half circle in a matter of approximately 25 years. By no means has it passed from the scene, but the ardor of its early apostles seems to have given way rather quickly to the doubting of skeptics."). Compare *Rights at Variance I*, *supra* note 24, at 967-69 (expressing a complimentary view of the doctrine) with William A. Mayhew, *Reasonable Expectations: Seeking a Principled Application*, 13 PEPP. L. REV. 267 *passim* (1986) (expressing a negatively critical view of the doctrine).

⁴⁵ Thus, to be distinguished are decisions that examine the pleadings to determine if the pleadings, *i.e.*, the *asserted claims*, state claims potentially within coverage. See, *e.g.*, *St. Paul Fire & Marine Ins. Co. v. Pryseski*, 438 A.2d 282 (Md. 1981):

In determining whether a liability insurer has a duty to provide its insured with a defense in a tort suit, two types of questions ordinarily must be answered: (1) what is the coverage and what are the defenses under the terms and requirements of the insurance policy? (2) do the allegations in the tort action potentially bring the tort claim within the policy's coverage? The first question focuses upon the language and requirements of the policy, and the second question focuses upon the allegations of the tort suit.

Id. at 285.

modern pleadings. In one often-cited comment, the court observed: "Defendant [insurer] cannot construct a formal fortress of the third party's pleadings and retreat behind its walls. The pleadings are malleable, changeable and amendable."⁴⁶ Unfortunately, in light of the problems that the court's adoption of the potentiality test subsequently engendered,⁴⁷ the fluidity and flexibility of modern pleading alone provides insufficient justification for triggering the duty to defend based on the potentiality that a covered claim might exist. The court never really explained why the malleability of pleadings justified placing the risk that a covered claim would be asserted on the insurer rather than the insured. Since the uncertainty was not created by the insurer, but by a third party, allocation of the risk to the insurer was not self-evident. The court may have simply deemed such uncertainties to

⁴⁶ Gray v. Zurich Ins. Co., 419 P.2d 168, 176 (Cal. 1966).

⁴⁷ The most prominent problem is conflicts of interest between insured and insurer. See generally Eric M. Holmes, *A Conflicts-of-Interest Roadmap for Insurance Defense Counsel: Walking an Ethical Tightrope Without a Net*, 26 WILLAMETTE L. REV. 1 (1989). Of course, in most cases the interests of insured and insurer are aligned. The common goal is to defeat the claim of the claimant. These cases do not involve disputes over coverage. Even in the absence of a coverage dispute, however, conflicts may exist between insured and insurer. These conflicts tend to be latent, whereas coverage disputes are patent. Examples of latent conflicts include situations where there is a possibility of an excess judgment and the insurer, because of low policy limits or an erroneous evaluation of the merits of the claim, lacks the motivation to vigorously defend against the claim. See, e.g., *Public Service Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810, 815 (N.Y. 1981). See generally 14 COUCH, *supra* note 7, § 51:79, at 569-72. Conflicts may also arise where the insured is both a party defendant and a party plaintiff. The insurer's preferred defense may conflict with the insured's theory of the case. Cf. *Rosenzweig v. Blinshteyn*, 544 N.Y.S.2d 865, 868 (App. Div. 1989) (finding that the trial court denied insured's fair trial by appointing counsel retained by insurer as sole trial counsel, where retained attorney attempted to avoid payment of money damages by arguing accident was unavoidable and this theory prejudiced insured's claim for damages against driver of other car); *Barney v. Aetna Casualty & Sur. Co.*, 230 Cal. Rptr. 215 (Ct. App. 1986) (holding that insurer breached duty owed to insured by settling case without preserving insured's right to pursue her individual claim against other party).

A related problem involves the extent to which the insurer has a duty to advance its own funds to settle a claim outside coverage. See *St. Paul Mercury Ins. Co. v. Ralee Eng'g Co.*, 804 F.2d 520, 522 (9th Cir. 1986) (ruling that insurer is not entitled to recover litigation costs where the record does not reflect an agreement or understanding that the insured would reimburse if there was no duty to defend).

be part of the bundle of risks transferred to the insurer by the insurance contract.

A contrary allocation is not, however, unthinkable. For instance, in *Burd v. Sussex Mutual Insurance Co.*,⁴⁸ on facts remarkably similar to those in *Gray*,⁴⁹ the New Jersey Supreme Court explicitly rejected allotting the risk of noncoverage to the insurer.⁵⁰ Rather, the court assigned the risk to the insured. Under *Burd*, whenever the insurer rejects a tender because a conflict of interest intertwines with a coverage dispute, the insured is relegated to an action for reimbursement of defense costs incurred.⁵¹ Under *Gray*, on the other hand, the risk of noncoverage is placed on the insurer by requiring the insurer to assume the defense in all cases of conflict or uncertainty over coverage. Yet the *Gray* court did not explain, aside from its references to "timing," why its approach was superior to a reimbursement rule, such as that adopted in *Burd*.⁵²

The *Gray* court also failed to provide any guidance on the proper dimensions of the potentiality test once the court decided to adopt it. This lack of guidance was the critical difficulty. Under the potentiality test, the duty to defend was not triggered by the actualities of objective factors, such as a pleading, or establishable facts, such as knowledge of the insurer that the claim was actually covered even though the pleadings were inconclusive or inaccurate.⁵³ The issue was not whether *asserted* claims stated a claim potentially within coverage.⁵⁴ Rather, the contractual duty

⁴⁸ 267 A.2d 7 (N.J. 1970).

⁴⁹ *Burd* was insured by Sussex. During an altercation with a person named D'Agostino, Burd shot D'Agostino. D'Agostino sued Burd for intentional and negligent conduct. Burd was convicted of criminal atrocious assault and battery, and Sussex declined coverage, arguing that Burd intentionally inflicted the injuries on D'Agostino. *Id.* at 8-9.

⁵⁰ Although the complaint stated a claim within coverage (negligence), Sussex had a conflict because the complaint contained both covered (negligence) and excluded (intentional tort) claims. It was this *conflict* that allowed Sussex to reject the tender. *Id.* at 11.

⁵¹ *See id.* at 12-13.

⁵² Nor, for that matter, did the court in *Burd* explain why the risk of noncoverage should be placed on the insured rather than the insurer.

⁵³ *See Aetna Casualty & Sur. Co. v. Freyer*, 411 N.E.2d 1157, 1160 (Ill. App. Ct. 1980); *Canoue v. Fireman's Fund Am. Ins. Co.*, 278 N.W.2d 49 (Minn. 1979); *cf. Continental Sav. Ass'n v. United States Fidelity & Guar. Co.*, 762 F.2d 1239, 1244 (5th Cir.), *amended per curiam*, 768 F.2d 89 (5th Cir. 1985).

⁵⁴ *See supra* note 45.

to defend was triggered by unasserted claims. The claimant might assert these presently unasserted claims in the future; but, of course, on the other hand, she might not. In other words, the duty was based on speculation about the future rather than the realities of the present.

In such circumstances, the duty to defend could not be based on the contractual language. Indeed, the court in *Gray* expressly separated its discussion of the potentiality test from its discussion of insurance contract interpretation,⁵⁵ which had independently led the court to find that a duty to defend existed.⁵⁶ Moreover, it would be rather remarkable if the insurance contract provided a contractual duty to defend based on a nonexistent, unasserted claim. If the duty to defend existed in such circumstances, why not the duty to indemnify? Where the existence of a covered claim is a condition to all contractual duties of the insurer, holding that a contractual duty arose because of the presence of a noncovered claim would fundamentally alter all thinking associated with insurance contracts. Finally, the *Gray* court was not entirely clear about the meaning of "potentiality," and subsequent decisions purporting to apply the potentiality test have carried forward this uncertainty.⁵⁷ Two interpretations of potentiality have already been noted. First, potentiality may refer to the existence of unasserted claims that would be within coverage.⁵⁸ Second, potentiality may refer to the possibility that asserted claims are within coverage.⁵⁹

⁵⁵ *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 171-75 (Cal. 1966).

⁵⁶ *Id.* at 176. Some courts have, nevertheless, ignored this explicit duality of *Gray* and limited the use of the potentiality test to situations where the insurance contract itself is ambiguous about whether coverage exists as to the potential, as yet unpleaded claim. *See, e.g.*, *Bowie v. Home Ins. Co.*, 923 F.2d 705, 708 (9th Cir. 1991); *Royal Globe Ins. Co. v. Whitaker*, 226 Cal. Rptr. 434, 436-37 (Ct. App. 1986).

⁵⁷ *See infra* note 65 and accompanying text (discussing relevant cases).

⁵⁸ *See, e.g.*, *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 126 Cal. Rptr. 267 (Ct. App. 1975); *cf.* *Continental Sav. Ass'n v. United States Fidelity & Guar. Co.*, 762 F.2d 1239, 1244 (5th Cir.) (stating that duty to defend would exist where complaint did not exclude the potential that the loss was covered, even though the complaint did not explicitly so assert), *amended*, 768 F.2d 89 (5th Cir. 1985).

⁵⁹ This appears to be the most common formulation of the potentiality test. *See* *Pattison v. Employers Reinsurance Corp.*, 900 F.2d 986, 988 (6th Cir. 1990) (holding that duty to defend depends on the potential shown in complaint that facts ultimately proved will fall within coverage); *Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620, 624 (8th Cir. 1981); *Technicon*

The difference between the two interpretations is largely one of perspective. Under the first interpretation, the decision-maker identifies the events giving rise to the asserted claims. Then she examines those events and compares them to relevant policy language to ascertain whether an unasserted claim within coverage may be hypothesized. Under the second interpretation, the decision-maker limits her review to the policy language and the asserted claim to ascertain whether that particular claim falls within coverage. The difference is that the first interpretation begins as an abstraction—can a covered claim be hypothesized?—while the second interpretation begins from a concrete foundation of facts alleged by a claimant. In many cases, starting at different vantage points may not affect the end result. In at least a few cases, however, beginning from an abstraction may result in a broader obligation to defend than would result from beginning from a concrete foundation of facts. This results because an abstraction allows the decision-maker greater freedom of choice, since the boundary that separates proper decisions from improper decisions is not clearly marked. Hence, it is difficult to identify whether the decision-maker has erred. While this fluidity in decision-making could result in either a more constraining or more expansive view of the duty to defend than is available under

Elects. Corp. v. American Home Assurance Co., 542 N.E.2d 1048, 1050 (N.Y. 1989); *Town Crier, Inc. v. Hume*, 721 F. Supp. 99 (E.D. Va. 1989). The court in *Town Crier* stated as follows:

The Virginia rule appears to be the combination of what are commonly referred to as the Exclusive Pleading Rule and the Potentiality Rule. The Exclusive Pleading Rule means that an insurer's duty to defend is determined solely by the allegations in the pleadings. The Potentiality Rule sets a broad outer boundary on the Exclusive Pleading Rule by stating that the insurer must still defend if there is any "potentiality" that the claim, as stated in the pleadings, could be covered by the policy.

The soundness of the Virginia rule is evident. It logically bases the duty to defend on the claims in the complaint. It also minimizes potential conflict between the insurer and the insured by limiting the defense duty to cases where the insurer has some risk to indemnify. To the extent that the risk is not eliminated, it is ameliorated by the insurer's duty to issue a reservation of rights notice with respect to any claims not covered. In those instances, insureds may retain personal counsel to represent their interests or to monitor the conduct of the defense by the insurer.

Id. at 102 n.12 (citations omitted).

the second interpretation, the judicial maxim that the duty to defend should be broadly construed leads me to believe that permitting judges to decide based on abstract possibilities would inevitably operate as a one-way ratchet.⁶⁰

The issue is further confused by the fact that some jurisdictions which apply the pleadings test use the term "potentiality,"⁶¹ while some jurisdictions that follow *Gray* also use "potentiality" in the limited sense of looking at the pleadings.⁶² Thus, particularly in notice pleadings jurisdictions,⁶³ the decisions do not clearly indicate how far beyond the pleadings test the courts are actually moving when they adopt the potentiality test.⁶⁴ If, when applying the "exclusive pleadings" test, a court may indulge in the most

⁶⁰ A third interpretation of the potentiality test, which focuses on the actuality of liability, is sometimes suggested. *See, e.g.*, *Tews Funeral Home, Inc. v. Ohio Casualty Ins. Co.*, 832 F.2d 1037, 1042 (7th Cir. 1987) (stating that "potentially covered" means that allegations in complaint give rise to possibility of recovery; there need not be a probability of recovery); *Idaho v. Bunker Hill Co.*, 647 F. Supp. 1064, 1070 (D. Idaho 1986) (holding that claim had arguable basis and there was potential for coverage even though court found no duty to indemnify). This test is not really a potentiality test, however. Under this test, an insurer is obligated to defend groundless, even frivolous claims within coverage. *See, e.g.*, *Nevada VTN v. General Ins. Co. of America*, 834 F.2d 770, 773 (9th Cir. 1987); *Ritter v. United States Fidelity & Guar. Co.*, 573 F.2d 539, 542 (8th Cir. 1978); *Maryland Casualty Co. v. Peppers*, 355 N.E.2d 24 (Ill. 1976); *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7, 10 (N.J. 1970). *See generally* 7C APPLEMAN, *supra* note 1, § 4682. This third test is, most likely, simply an inapt expression by courts of either the first or second interpretation of potentiality.

⁶¹ *See supra* note 45 (discussing Maryland case employing the term "potentially"). Maryland is an "exclusive pleadings" jurisdiction. *See Eastern Shore Fin. Resources, Ltd. v. Donegal Mut. Ins. Co.*, 581 A.2d 452, 458-61 (Md. Ct. Spec. App. 1990).

⁶² *See supra* note 59.

⁶³ *See* FED. R. CIV. P. 8. Many states have adopted the federal rules, including the notice pleading concept. *See* 4 CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE CIVIL 2D § 1008 (1987). The same result is achieved in some code jurisdictions by liberal use of amendments to pleadings. *See Smeltzley v. Nicholson Mfg. Co.*, 559 P.2d 624 (Cal. 1977) (allowing amended pleading where amendment rests on same general facts as set forth in superceded pleadings).

⁶⁴ *See* *Ross Island Sand & Gravel Co. v. General Ins. Co. of Am.*, 472 F.2d 750, 752 (9th Cir. 1973) ("In [a notice pleading jurisdiction], a complaint may or may not provide an insurance carrier with enough information to permit an informed judgment on whether or not he must defend."); *see also* *Thornton v. Paul*, 384 N.E.2d 335, 347-48 (Ill. 1979); *Kepner v. Western Fire Ins. Co.*, 509 P.2d 722 (Ariz. 1973).

liberal interpretation of the allegations to which they are susceptible, then the differences between the *Gray* test and the "exclusive pleadings" test would be nonexistent in most cases and small in the remainder.

The significance of *Gray* lay in the court's willingness to extend the boundaries of the insurer's duty to defend beyond the modest extensions accomplished under the pleadings test. Under the liberalized pleadings test, courts had extended the duty to defend to situations where a substantial likelihood existed that the claimant would assert a covered claim. In *Gray*, the court extended the duty to defend to situations where the likelihood that the claimant would assert a covered claim was much less. As a consequence, *Gray*'s potentiality test permits courts to base coverage decisions on whether a legally sufficient claim can be abstracted from the dispute between the third party and the insured.

C. *The Limits of Gray*

In *Gray*, the court never specified what degree of probability was necessary to satisfy the potentiality test. Since *Gray*, however, courts have tended to require only a slight degree of potential. Thus, an insurer has a duty to defend its insured even if the potential that the claimant will assert a covered claim is remote.⁶⁵ Remoteness, however, is not the only question raised by *Gray*. For instance, under *Gray*, does the duty to defend arise if the potential claim is without legal merit?

Assume that two painters, employed by X, were injured in a fall

⁶⁵ See *CNA Casualty of Cal. v. Seaboard Sur. Co.*, 222 Cal. Rptr. 276, 278-79 (Ct. App. 1986); *California Union Ins. Co. v. Club Acquarius, Inc.*, 169 Cal. Rptr. 685, 686 (Ct. App. 1980); *Fresno Economy Import Used Cars, Inc. v. United States Fidelity & Guar. Co.*, 142 Cal. Rptr. 681, 685 (Ct. App. 1977). This approach has been followed in other jurisdictions that have adopted the "potentiality" test. See *St. Paul Fire & Marine Ins. Co. v. Vigilant Ins. Co.*, 919 F.2d 235, 240 (4th Cir. 1990) (applying North Carolina law) ("If there is *any* chance that [the insured's] claim even *arguably* developed during the Vigilant policy period, Vigilant has a duty to defend."). But see *National Union Fire Ins. Co. of Pittsburgh v. Siliconix Inc.*, 726 F. Supp. 264, 272 (N.D. Cal. 1989) (finding no duty to defend where possibility that covered claim would be asserted was "extremely remote and not suggested by either the complaint . . . nor by facts known to the insurer and insured"); *Fire Ins. Exch. v. Jiminez*, 229 Cal. Rptr. 83, 86 (Ct. App. 1986) (finding no duty to defend where uncontradicted evidence demonstrated that there was no coverage).

from scaffolding furnished by *Y*.⁶⁶ The two employees sued *Y* for their injuries, alleging that the scaffolding was unsafe and defective and that *Y* had failed to provide required safety equipment. *Y* cross-claims against *X* for indemnification. On these facts, is *X*'s insurer obligated to defend *X* on the cross-claim by *Y*?

Assume further that *X* had agreed to indemnify and hold *Y* harmless by signing the rental agreement for the scaffolding, which contained a provision to that effect. Thus, *Y*'s cross-claim is susceptible to two theories of recovery: (1) *X*'s negligence was primary, whereas *Y*'s was secondary (implied indemnification); or (2) *X* had agreed to indemnify and hold *Y* harmless (express indemnification). Assume, however, that *X*'s potential liability to *Y* is limited by the state's workers compensation law, which insulates an employer (*X*) from having to reimburse or hold another (*Y*) harmless from judgment or settlements against the latter in the absence of a written agreement to do so executed prior to the injury.⁶⁷ Consequently, only if *X* executed such an agreement would *X* be required to indemnify *Y*. On the other hand, assume that under the terms of *X*'s policy, if *X* executed such an agreement, *Y*'s cross-claim would be excluded from coverage.⁶⁸ If *Y* asserts a claim for implied indemnification without alleging the existence of the written agreement, does the duty to defend attach?

Y's cross-claim seems to satisfy the *Gray* test. The asserted claim, albeit a legally meritless one because of the statute, would be a claim within coverage. The insured is entitled to a defense of meritless claims as well as meritorious claims, as long as the claims asserted against the insured are within coverage. More-

⁶⁶ The facts used in this hypothetical were derived from those in *Val's Painting & Drywall, Inc. v. Allstate Ins. Co.*, 126 Cal. Rptr. 267 (Ct. App. 1975).

⁶⁷ See, e.g., CAL. LABOR CODE § 3864 (West 1989).

⁶⁸ See 12 COUCH, *supra* note 7, § 44A:35:

Liability insurance policies not infrequently contain provisions specifically excluding from coverage liability assumed by the insured under a contract not defined in the policy. Such provisions, which may be referred to as "contractual exclusion clauses," deny the coverage generally assumed by a liability policy in cases in which the insured in a contract with a third party agrees to save harmless or indemnify such third party.

Id. at 55; see also *Olympic, Inc. v. Providence Wash. Ins. Co. of Alaska*, 648 P.2d 1008, 1010 (Alaska 1982); *Fresard v. Michigan Millers Mut. Ins. Co.*, 327 N.W.2d 286 (Mich. 1982).

over, once the duty to defend attaches, the defense obligation extends to the entire lawsuit: "An insurer, bound to defend an action against its insured, must defend against all of the claims involved in that action, even though some . . . of them ultimately result in recovery for damages not covered by the policy."⁶⁹

Assume, however, that instead of asserting the claim for implied indemnification, *Y* alleges the existence of the written agreement, thus asserting a claim for express indemnification. In this instance, the court would have to determine the extent to which an unasserted, groundless, but covered claim (implied indemnification) would control over an asserted, potentially viable, but excluded from coverage claim (express indemnification). Basing the duty to defend on the unasserted claim would be particularly vexing for the insurer because the insurer would have a good defense to the claim if the claim were ever asserted, which, of course, it would not be because the claim would fail.⁷⁰ More importantly, if the abstract presence of an unasserted, groundless, but covered claim were sufficient to hold the insurer in the litigation until the conclusion of the entire dispute, coverage provisions would have no real significance in the duty to defend context.⁷¹ The insured could always hypothesize the existence of an unasserted, groundless, but covered claim within the facts of the dispute.⁷² Such a test for triggering the duty to defend would

⁶⁹ *California Union Ins. Co. v. Club Acquarius, Inc.*, 169 Cal. Rptr. 685, 687 (Ct. App. 1980). Other jurisdictions follow this approach. See *Ruder & Finn Inc. v. Seaboard Sur. Co.*, 422 N.E.2d 518, 521 (N.Y. 1981). See generally 7C APPLEMAN, *supra* note 1, § 4684.01, at 102; JERRY, *supra* note 29, § 111(c)[4]. The only recognized exception to this rule is if the "insurer produces undeniable evidence of the allocability of specific expenses." *Hogan v. Midland Natal Ins. Co.*, 476 P.2d 825, 831 (Cal. 1970). See generally *Voorhees v. Preferred Mut. Ins.*, 588 A.2d 417, 425 (N.J. Super. Ct. App. Div. 1991) (discussing relevant cases).

⁷⁰ The position of the insurer in this scenario is doubly vexing. How do you defend against an unasserted claim? If you can defend against it or encourage the claimant to assert it, so that you can defeat it (and the basis for invoking the duty to defend), haven't you, as an insurer, violated your duty to respect and protect the interest of the insured?

⁷¹ Courts consistently hold that the duty to defend groundless claims within coverage does not obligate the insurer to defend *all* claims. See 14 COUCH, *supra* note 7, § 51:46.

⁷² There is a related problem that arises where the claimant asserts a groundless but covered claim and this is the only basis for triggering the insurer's duty to defend. Must the insurer remain on the defense after the groundless claim is dismissed? The issue has received surprisingly little

raise the profound issue of abuse by manipulation of the pleading for no other purpose than to involve the insurer and, by exposing it to the costs of litigation, encourage it to settle claims outside of coverage. The claimant can, of course, legitimately structure the pleading with an eye to maximizing the likelihood of actual recov-

attention. Most courts appear to hold that once the duty to defend attaches, it continues until terminated pursuant to the terms of the insurance contract. *See, e.g.,* *Kocse v. Liberty Mut. Ins. Co.*, 387 A.2d 1259 (N.J. Super. Ct. Law Div. 1978) (discussing relevant cases); *Exchange Mut. Ins. Co. v. Geiser*, 498 N.Y.S.2d 291, 292 (Sup. Ct. 1986) (relying on fact that policy as amended no longer terminated duty to defend when its "limit of liability for this coverage has been exhausted" and policy also provided that "[i]n addition to our limit of liability, we will pay all defense costs we incur"); *see also* 7C APPLEMAN, *supra* note 1, § 4682, at 34 ("The insurer's obligation to defend suits against the insured is not divisible and therefore it is not limited to suits which are only within policy limits, but, once the policy limits have been exhausted through payment or settlement the duty to defend ceases under many current policies.") (footnotes omitted). Indeed, in some cases it appears that once the duty to defend attaches it cannot be severed. *Cf. Ohio Casualty Ins. Co. v. Hubbard*, 208 Cal. Rptr. 806 (Ct. App. 1984) (holding that duty to defend continued after insurer exhausted policy limits and even though only noncovered claim for punitive damages remained). There are a few decisions, however, which recognize that if the action is subsequently confined to noncovered claims, the duty to defend ceases. *See* 7C APPLEMAN, *supra* note 1, § 4684.01, at 107 (discussing relevant cases).

The real possibility that under current law the insurer could be required to defend noncovered claims based solely on the presence of a pleaded groundless claim suggests that our approach to this problem must be sensitive to the needs of both insureds and insurers. Insureds must be treated fairly, but they are not entitled to windfall defenses based on the fortuitous presence of groundless but covered claims. At the minimum, the appropriate boundaries of the defense obligation need to be identified, as do the thresholds necessary to trigger the duty to defend. If public policy requires that the initial call whether the duty attaches be made broadly and expansively, then appropriate safeguards should be created to protect insurers from the inevitable mistakes that will arise given the pro-insured perspective from which the initial call is made. Indeed, along the lines previously noted, unless some limitations on the obligation of the insurer to defend whenever a groundless but covered claim is present are recognized, the duty to defend has no limitations. *Cf. National Union Fire Ins. Co. of Pittsburgh v. Siliconix, Inc.*, 726 F. Supp. 264 (N.D. Cal. 1989). In *Siliconix*, because of certain coverage questions, the insured had selected its own counsel, who were being paid by the insurer. After one covered claim was dismissed, the insurer brought a declaratory relief action to secure a declaration that it had no further duty to pay for or provide a defense to the insured. The court granted the request, placing particular emphasis on the fact that the litigation decisions leading to the dismissal of the covered claim had been made exclusively by the insured. *Id.* at 270.

ery. Asserting a groundless claim for no other purpose than to involve an insurer, however, suggests a violation of an advocate's duty to present meritorious claims and defenses.⁷³

Limited decisional law exists recognizing that where the *only* basis for activating the duty to defend is a patently groundless claim, the insurer may refuse the tender.⁷⁴ The decisional law in some jurisdictions, such as California, however, does not provide much comfort to insurers on this point.⁷⁵ Nonetheless, California decisional law does support a narrow right to reject the tender.

⁷³ See MODEL RULES OF PROFESSIONAL CONDUCT Rule 3.1 (1990); *cf.* Thornton v. Paul, 384 N.E.2d 335 (Ill. 1979):

[A] few observations concerning the procedural maneuvering by the plaintiff surrounding the execution of the agreement and the use made of it are at this time appropriate. With the exception of the amended complaint, all the facts, depositions and pleadings in the present case clearly indicate that the claim was based on an intentional battery by Ben Paul, not on negligence. It is equally clear that the plaintiff's attorney was well aware that the defendant's act was a battery and that he filed the amended complaint charging negligence solely for the purpose of bringing the action within potential insurance coverage, thereby intending to obligate the insurer to defend after the insurance company had investigated, learned that the conduct was a battery, and refused. There is no explanation for the procedures followed other than the desire of plaintiff's counsel to maneuver the insurer into a position where it would be obligated to pay the judgment and estopped from raising the defense of noncoverage.

Id. at 340. The court went on to note that the entering into of a nonexecution agreement between the victim and the insured in exchange for an assignment of the insured's rights against the insurer, coupled with the fact that the insurer was kept in the dark and the fact that the insured presented no defense to the victim's claims, constituted "sharp practices." On other grounds, the court allowed the insurer to contest coverage notwithstanding its rejection of a technically valid tender of the defense. *Id.*

⁷⁴ See Lionel Freedman, Inc. v. Glen Falls Ins. Co., 267 N.E.2d 93, 95 (N.Y. 1971) (holding that the mere use of the word "negligence" cannot turn an excluded claim into a covered claim when the pleadings cannot be reasonably construed to contain a covered action). *But cf.* K.L. Pattison v. Employers Reinsurance Group, 900 F.2d 986 (6th Cir. 1990) (stating that legal theory rather than nature of relief determines whether duty to defend attaches; exclusion only encompassed breach of contract theories for premium recovery; claimant sought premium recovery based on insured's negligence).

⁷⁵ See CNA Casualty of Cal. v. Seaboard Sur. Co., 222 Cal. Rptr. 276, 279 (Ct. App. 1986) (concluding that where the insurance policy obligates the insurer to defend "groundless, false and fraudulent" claims, the insured is

Where the duty to defend does not appear from the facts pleaded in the complaint *and* the insurer's investigation adduces no grounds for concluding that the claim is actually or potentially covered, the insurer may reject the tender.⁷⁶ The risk of an erroneous rejection, however, lies entirely with the insurer. The insured, or the claimant on obtaining an assignment of the insured's cause of action against the insurer, may contest the insurer's decision.⁷⁷ Under the California approach, the insurer can reject the tender with confidence only in those situations where, as a practical matter, the claimant cannot assert a covered claim against the insured. Since, by definition, such cases do not raise a real "potential" claim, they provide little help on this point for the insurer. An insurer can reject a tender safely only in those situations where decisional law expressly holds that no coverage exists.⁷⁸

Under the *Gray* test, however, courts should require real, not remote, potential. A realistic likelihood should exist that an actual claim will be asserted. And a claim that is stillborn on its assertion hardly constitutes a true potential claim. The potential inherent in every action for a claimant to assert a "groundless" claim should not activate the duty to defend.⁷⁹ Thus, at a minimum, the potential claim must be legally viable.

But legal viability also sets the limit of appropriate inquiry. In other words, if a potential claim is legally viable, the insurer must accept the tender if that claim could be asserted in the dispute between the claimant and the insured. Any more exacting test, besides resting on terms that are insufficiently precise to allow the insurer or the insured to make a confident decision whether the duty to defend has attached, places both insurer and insured in an

entitled to the defense of the claim framed by the complaint even if the insurer has knowledge that the injury is not in fact covered).

⁷⁶ See *Hartford Fire Ins. Co. v. Superior Court*, 191 Cal. Rptr. 37, 41 (Ct. App. 1983); *Fire Exch. Co. v. Jiminez*, 229 Cal. Rptr. 83, 86 (Ct. App. 1986).

⁷⁷ *Mullen v. Glen Falls Ins. Co.*, 140 Cal. Rptr. 605, 611 (Ct. App. 1977).

⁷⁸ See, e.g., *Minnigh v. American Mfrs. Mut. Ins. Co.*, 713 F. Supp. 366 (C.D. Cal. 1989) (finding that the consistent approach under California law has been to hold that wrongful discharge claims are outside coverage provided by liability insurance). See generally Roxanne L. Holmes, *Insurance Coverage for Claims of Wrongful Employment Termination*, 91 DICK. L. REV. 895 (1987).

⁷⁹ The obligation to defend "groundless" claims thus extends only to pleaded "groundless" claims within coverage. See *supra* notes 66-73 and accompanying text (discussing groundless but covered claims).

irreconcilable and mutually disadvantageous position vis á vis the claimant if they seek to obtain an immediate adjudication whether the duty has been triggered. Thus, no counterweight exists to the definite advantages that are obtained under the potentiality test as a trigger for the duty to defend beyond requiring that the potential claim be within coverage and legally viable.

D. The "Apparent" Duty to Defend

On occasion, the issue of coverage turns not on whether the potential claim is legally viable, but on whether it is asserted against an "insured." For example, the standard automobile liability policy contains a "permissive use" clause that extends coverage to those persons who operate the covered vehicle with the permission of the named insured. Thus, if a person other than a named insured negligently operates a covered vehicle resulting in a claim, there is no question but that the *claim* is covered. There may be, however, a significant issue whether the *operator* of the vehicle is covered. Do the same rules that govern the insurer's duty to defend against potential claims apply to cases involving potential insureds?

Assume that Claimant sues *X* for personal injuries, alleging that *X* was operating the vehicle that struck Claimant and that *X* was operating the vehicle as the agent and employee of the named insured (Insured). *X* tenders the defense to Insured's insurer (Insurer). Insurer conducts a preliminary investigation and discovers one of the following situations: (1) Insured gave *X* permission to use the vehicle, but *X* violated the terms and conditions of the grant and was doing so at the time of the accident with Claimant;⁸⁰ (2) Insured gave *Z* and no one else permission to use the

⁸⁰ See, e.g., *Jordan v. Consolidated Mut. Ins. Co.*, 130 Cal. Rptr. 446 (Ct. App. 1976):

The question presented is the effect of use of the insured vehicle by a permissive user in excess of permission given. "Courts faced with this question have adopted one of three views: (1) The liberal or so-called 'initial permission' rule that if a person has permission to use an automobile in the first instance, any subsequent use while it remains in his possession though not within the contemplation of the parties is a permissive use within the terms of the omnibus clause; . . . (2) the moderate or 'minor deviation' rule that the permittee is covered under the omnibus clause so long as his deviation from the permissive use is minor in nature; . . . and (3) the strict or 'conversion' rule that any deviation from the time, place or purpose specified by the

vehicle, but Z violated the terms of the grant by giving X permission to operate the vehicle;⁸¹ or (3) Insured left the vehicle parked on the street, but X, who belongs to a sect that believes all goods are publicly owned, "hot-wired" the vehicle so he would not be late to an event he wished to attend.⁸²

person granting permission is sufficient to take the permittee outside the coverage of the omnibus clause; . . ." The only limitation on the "initial permission" rule is that the subsequent use must not be equivalent to "theft or the like."

Id. at 452-53 (footnote and citations omitted) (quoting *Matits v. Nationwide Mut. Ins. Co.*, 166 A.2d 345, 347, 349 (N.J. 1960)).

⁸¹ See, e.g., *Curtis v. State Farm Mut. Auto. Ins. Co.*, 591 F.2d 572 (10th Cir. 1979):

In view of the broad permission given by the parents to Beth and Shawna for use of the family cars, an inference might be drawn that the older daughters as first permittees could permit Deborah to use the Volkswagen. . . .

The difficulty, however, is that here it is not the driving of Deborah as a second permittee which is in question, but that of Wallace as a *third* permittee. We note again that neither of the first permittees, Beth and Shawna, were told by Deborah that Wallace was to be in the car with Deborah and Helen. We are convinced that implied permission cannot be stretched so far as to include the driving of Wallace on the night of the accident. . . . A scintilla of evidence, such as the remote permission of the parents given to Beth and Shawna to drive the family cars, was not enough to raise a jury question of implied permission for Wallace to drive the Volkswagen.

Id. at 576-77 (footnote and citations omitted). The cases are prolific in their factual variations on this issue. See generally Jay M. Zitter, Annotation, *Omnibus Clause As Extending Automobile Liability Coverage to Third Persons Using Car with Consent of Permittee of Named Insured*, 21 A.L.R.4th 1146 (1983).

⁸² Cf. *Colon v. Aetna Life & Casualty Ins. Co.*, 484 N.E.2d 1040 (N.Y. 1985) (holding that insurer must provide defense to driver of vehicle who is alleged to have operated vehicle with the owner's consent). The dissenting judge in *Colon* observed:

Taken to its logical conclusion, the majority would require a carrier to supply counsel to a thief. Depending upon how cleverly the complaint is drafted—and form book complaints routinely assert the magic words concerning the owner's "consent and permission"—the thief can always assert some sort of implied consent as, for example, claiming that the motorist left the key in the ignition. The possibility is hardly farfetched for a thief is not necessarily judgment-proof and it certainly would be in the interest of both the thief and the personal injury plaintiff to make such assertions as the carrier may well be encouraged to settle. This unacceptable prospect was previously unthinkable.

Each hypothetical represents a case where the insurer is aware of facts that vary from those alleged in the claimant's complaint. Does the variance allow the insurer to refuse the tender of the defense by X in any of the hypotheticals? I believe that most readers will agree that, intuitively, the third hypothetical presents the strongest case for denying a duty to defend. Why should the "thief" be allowed to rely on the named insured's prudence in securing an insurance policy? Yet, unless we can come up with defensible distinctions between the hypotheticals, we must either treat each alike or recognize that our "distinctions" rest more on naked preference than principle, because in each instance the facts known to the insurer indicate an excluded claim. In *Burd v. Sussex Mutual Insurance Co.*,⁸³ the New Jersey Supreme Court suggested a principled distinction based on differentiating between cases where facts relevant to coverage were also relevant to the litigation of the claim asserted against the "insured" and cases where coverage facts were irrelevant.⁸⁴ This distinction provides a limited escape valve for insurers, although it will receive much greater use in situations where the insurer believes it has a defense to coverage based on a contract defense such as breach of warranty,⁸⁵ failure of condition,⁸⁶ or misrepresentation.⁸⁷ Under

Id. at 1043 (Titone, J., dissenting) (citations omitted). *But cf.* *Allstate Ins. Co. v. United States Fidelity & Guar. Co.*, 663 F. Supp. 548 (W.D. Ark. 1987) (finding no duty to defend where fraternity brother took a vehicle owned by father of another "brother" because driver thought "owner" would not care), *aff'd sub nom.* *United States Fidelity & Guar. Co. v. Compton*, 846 F.2d 1147 (8th Cir. 1988). *See generally* 7C APPLEMAN, *supra* note 1, § 4685.

⁸³ 267 A.2d 7 (N.J. 1970).

⁸⁴ But when coverage, *i.e.*, the duty to pay, depends upon a factual issue which will not be resolved by the trial of the third party's suit against the insured, the duty to defend may depend upon the actual facts and not upon the allegations in the complaint. So, for example, if a policy covered a Ford but not a Chevrolet also owned by the insured, the carrier would not be obligated to defend a third party's complaint against the insured which alleged the automobile involved was the Ford when in fact the car involved was the Chevrolet. The identity of the car, upon which coverage depends, would be irrelevant to the trial of the negligence action.

Id. at 9-10; *see also* *Allstate Ins. Co. v. Harris*, 445 F. Supp. 847, 851 (N.D. Cal. 1978) ("[Where] the critical issue for purposes of coverage will not be decided in the tort action . . . the Courts of Appeals have uniformly held that it is an abuse of discretion for a District Court to dismiss declaratory judgment actions brought by insurance carriers.").

⁸⁵ *See, e.g.*, *Purcell v. Pacific Auto. Ins. Co.*, 64 P.2d 1114 (Cal. Ct. App.

Burd, the insurer will be permitted to contest coverage by means of an action for declaratory relief⁸⁸ when the insurer's position of

1937) (holding that insurance voided when insured breached warranty that car would be garaged in Bakersfield by garaging and using car in Los Angeles (approximately 100 miles away) where insurance rates were higher).

⁸⁶ See e.g., *Miller v. Dilts*, 463 N.E.2d 257 (Ind. 1984) (stating that prompt notice is condition precedent to coverage; cooperation of insured is condition subsequent). See generally 8 JOHN A. APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW & PRACTICE* § 4732 (1981).

⁸⁷ See *Countryside Casualty Co. v. Orr*, 523 F.2d 870 (8th Cir. 1975) (holding that misrepresentation by insured on policy application voids coverage).

⁸⁸ A significant legal obstacle to the insurer bringing a declaratory relief action is the often-invoked rule of exclusive concurrent jurisdiction. The California approach to the problem is illustrative of the modern view. In *Lawyer Title Ins. Corp. v. Superior Court*, 199 Cal. Rptr. 1 (Ct. App. 1984), the court noted:

Under the rule of exclusive concurrent jurisdiction, when two superior courts have concurrent jurisdiction over the subject matter and the parties, the first court to assume jurisdiction has exclusive and continuing jurisdiction until such time as all necessarily related matters have been resolved. A writ of prohibition is an appropriate remedy when the second court refuses to recognize this exclusive jurisdiction.

Id. at 4 (citations omitted). Two exceptions are recognized in third-party coverage cases. In the first exception, the critical issue is whether the issue involved in the declaratory relief action is identical to that raised in the pending tort action. If it is, the later-in-time declaratory relief action should be dismissed, at least where no construction of the insurance policy is needed to resolve the coverage issue. See, e.g., *General of America Ins. Co. v. Lilly*, 65 Cal. Rptr. 750 (Ct. App. 1968) (holding that insurer could not maintain action seeking declaration that operator of vehicle was not acting within the course and scope of employment as that issue would be litigated in pending damages action brought by claimant). The second exception holds that even though another action involving the same subject matter and parties is pending when the declaratory relief action is filed, the second action need not be abated where the interests of the insurer and insured conflict, but must be abated where their interests are aligned. *Allstate Ins. Co. v. Fisher*, 107 Cal. Rptr. 251 (Ct. App. 1973). For example, compare *Allstate Ins. Co. v. Fisher*, *supra*, with *General Ins. Co. v. Whitmore*, 45 Cal. Rptr. 556 (Ct. App. 1965). In *Allstate*, the claimant sued the insured and the alleged permissive user (additional insured) for injuries caused by negligent operation of a vehicle by the permissive user. The insurer then sought a declaratory judgment that operation of vehicle was without permission of the named insured. The court denied declaratory relief because the interests of both the named insured and the insurer were aligned—both had taken the position that the operator was not using the vehicle with the per-

no coverage will not prejudice the insured in her defense of the underlying claim.

It is questionable, however, whether the *Burd* distinction would apply in the situation described in the third hypothetical. The decision that *X* (the putative insured) is a "thief" and was not operating the vehicle with the "permission" of Insured does not prejudice Insured; it does, however, prejudice *X*. And while *X* may not, after the fact, be deserving of our sympathy, it is difficult to distinguish *X*'s prejudice from the prejudice that would have been sustained by Dr. Gray, the insured in *Gray v. Zurich Insurance Co.*, if the court had allowed Zurich to escape coverage by showing that Dr. Gray had committed an intentional tort rather than mere negligence. The point to remember is that we are fastening the duty to defend on the insurer based on possibilities, not actualities. If we legally "knew" *X* was a "thief" when the defense was tendered, the case would be easy, just as it would be easy if we legally knew whether Dr. Gray acted negligently or intentionally when he injured the driver of the other car who sued him for assault. Since we do not legally know, we must base the decision whether to require the insurer to assume the defense of the "insured" on some other fact. The status of *X* as the agent and employee of the owner-named insured's is not sufficiently collateral to the question of the status of *X* as a permissive user for coverage purposes to warrant application of the *Burd* rule. Since the strongest case for allowing the insurer to escape the duty to defend fails, it would likewise appear that the duty to defend would attach in the first and second hypotheticals.

Once a jurisdiction accepts the premise that the insurer's duty to defend can be based on the "potential" that a covered claim *may* be asserted, it is impossible to impose significant limits on the rule. The potentiality test has no effective, nonarbitrary thresh-

mission of the named insured. In *General*, the insurer sought a declaratory judgment that there was no coverage because injury to the claimant was the result of an intentional act of the insured. The court found that the interests of the insurer and the insured were not aligned because such a finding would have relieved the insurer of liability and fixed liability on the insured.

It should be noted that this exception creates an anomaly. The insurer can obtain an expeditious adjudication of noncoverage as to the named insured, but it cannot obtain such a decision in cases involving "putative insureds," such as alleged "permissive users," because in such cases the named insured is invariably contending, along with the insurer, that the operator's use was without permission; thus, their interests are aligned.

old aside from the basic requirement that the “potential” claim be one that is legally cognizable in the jurisdiction. Other constraints must be understood as simply ad hoc limitations imposed by courts concerned about the limitless exposure the potentiality test provides.

III. JUSTIFYING AN EXTRA-CONTRACTUAL DUTY TO DEFEND

A major consequence of adopting the potentiality test is that the insurer is frequently called upon to defend a lawsuit consisting of claims that are outside insurance policy coverage. I do not question the extension of the duty to defend based on a principled construction of the insurance contract and a finding that the claim asserted against the insured is covered. The question here is whether the decision to require the insurer to assume a duty to defend an excluded claim based on unasserted claims can be described as contract-based. If the concepts of coverage provisions and exclusions are to have any meaning, I think the answer must be “no.” The imposition of such an obligation can be justified only by reference to public policy considerations that expand contractual obligations beyond the four corners of the insurance contract. The absence of a clear understanding of what constitutes “potentiality,” as demonstrated by the different viewpoints one may take to determine if a claim potentially within coverage has been, can be, or will be asserted to some degree of possibility, complicates the issue.

Positing potentiality on examination of *asserted* claims would tend to reduce the risk that courts would base coverage on abstract claims. Looking at the asserted claims and the facts that support them, rather than unasserted claims—particularly claims that are legally suspect—would provide a firmer foundation for extension of the duty to defend. However, a more restrictive vantage point is neither a straitjacket nor a panacea for the ills claimed by insurers. Use of the term “potentiality” necessarily moves courts beyond the four corners of the complaint to determine if the duty to defend attaches in a particular case. It is the propriety of moving outside the contract to determine the scope of contractual duties that I now wish to explore.

It is surprising that the broad expansion of the insurer’s duty to defend failed to generate any detailed explanation of why the expansion was necessary or desirable. Unquestionably, the insurer has a strong interest in minimizing its exposure whenever

it has a duty to indemnify, and the insurer can best vindicate that interest in most instances by controlling the defense.⁸⁹ Yet, as desirable as control may be for the insurer, this desirability does not justify forcing an insurer against its will to assume the defense of an insured. No doubt insurers would be well-advised to assume control of the defense in all close cases, at least where the costs of defense would not dwarf full indemnity, but that simply begs the question why the law needs to force insurers to do what is in their economic interest to do anyway.

One suspects that most cases of insurer-insured conflicts here involve attempts to force insurers to provide a defense for the insured where the true risk of indemnification is low and the costs of defense are high. If the insurer can be drafted into providing a defense, economic realities may force a settlement. Usually, the insurer will settle whenever the insurer perceives that the costs of settlement are less than the costs of providing a defense.⁹⁰ Moreover, even if the claim of noncoverage is sound, no insurer can accurately forecast individual decisions. The trial result may be bad, and it is a result the insurer will be stuck with. Finally, to add insult to injury, if the insurer mismanages the defense, extra-contractual liability may exist. Settlements *paid for by the insurer* avoid these economically unpleasant possibilities.

Without acknowledging this larger reality, courts have justified expansion of the duty to defend by relying on the "malleability of pleadings" rationale that soon was corrupted into the brief refrain that the duty to defend is broader than the duty to indem-

⁸⁹ It is for that reason that most courts will not permit the insurer simultaneously and over the insured's objection to control the defense and contest the issue of coverage. See *United Services Auto. Ass'n v. Morris*, 741 P.2d 246, 251 (Ariz. 1987) ("A majority of courts resolve this type of conflict by permitting the insured to reject a defense offered under a reservation of rights. The insured thus forces the insurer to elect either to defend unconditionally or to refuse to defend at its peril.") (citations omitted). *But see* *Ezell v. Hayes Oilfield Constr. Co.*, 693 F.2d 489, 494 (5th Cir. 1982) (stating that where conflict exists, insurer can insist on conditional defense under reservation of rights), *cert. denied, sub nom. Hayes Oilfield Constr. Co. v. United States Fidelity & Guar. Co.*, 464 U.S. 818 (1983). Where the insured is given the right to reject a conditional defense, the rejection cannot be equivocal. Thus, if the insured accepts money from the insurer to pay for the defense of the underlying claim, she may not be able to stand on her rejection of the reservation of rights letter. See *Walbrook Ins. Co. v. Goshgarian & Goshgarian*, 726 F. Supp. 777, 784 (C.D. Cal. 1989).

⁹⁰ The analysis is obviously more complex in reality than I have made it out to be. The insurer cannot buy "peace" at any price.

nify.⁹¹ But that was so only because courts said it was so, and it still remains to be explained persuasively why courts should require the insurer to assume the duty to defend claims outside contractual coverage. After all, an insured may die by accident or by natural causes, but the possibility that she may die of the former does not obligate the insurer to pay double indemnity based on accidental death when she dies of the latter. The potential that an event may occur does not support the argument that we should treat the event as having occurred before it has actually occurred or that we should necessarily anticipate the inevitability of its occurrence. The pre-*Gray* cases justifiably relaxed the pleadings test in cases where the insurer knew that the actual claim being asserted against the insured was covered because a strong likelihood existed that facts known to the insurer were known or would soon be known to the claimant and because a corresponding high degree of probability existed that a claim which was within coverage would be asserted against the insured. No such basis in factual expectancy exists when the potentiality test is based on speculation and abstraction rather than facts.

Nonetheless, the absence of a stated, sound justification in *Gray* for expanding the insurer's duty to defend does not mean that the *Gray* decision was wrong. The difficulty with the *Gray* potentiality test is that it rests on what the court appeared to assume was a self-evident proposition: the duty to defend is necessarily broader than the duty to indemnify because the former must be decided at the outset while the latter can be decided at the conclusion of the lawsuit. Yet, as noted earlier, there is nothing necessary about prior determination of the duty to defend.

Any attempted resolution of the problem posed in *Gray* must be done with full awareness of the inherent dilemmas attendant to any resolution. The bifurcation of the duty to defend from the duty to indemnify, coupled with the fact that not all claims will, in the end, be subject to indemnification, means that the insurer-insured relationship possesses inherent conflict in many cases. If the insurer is held to have no duty to defend in cases where a known or pleaded claim would not be subject to indemnification if successful—in other words, if potentiality is rejected—the cost

⁹¹ See, e.g., *Solo Cup Co. v. Federal Ins. Co.*, 619 F.2d 1178, 1183 (7th Cir.), cert. denied, 449 U.S. 1033 (1980); *Western World Ins. Co., Inc. v. Cigna Corp.*, 718 F. Supp. 1518, 1520 (S.D. Fla. 1989). See generally 7C APPLEMAN, *supra* note 1, § 4684, at 83-85.

of litigation is initially placed on the insured.⁹² Depending on what occurs during trial and pretrial, the cost of litigation may shift to the insurer.⁹³ In any event, if the insured's liability to the claimant is ultimately established, the insured will have to seek indemnification from the insurer.⁹⁴ Since the interests of insurer and insured here are diverse because the insured will conduct the defense to place any adjudicated liability as much as possible within any covered claims, insurers will resist a high number of these claims for indemnification. Because in many of these cases the coverage claim will be weak to begin with, insurers will be encouraged to contest coverage if they can. Insurers will probably win a significant number of these contests where the coverage claim is weak.

On the other hand, if the duty to defend is extended to situations where a claim potentially within coverage exists, the insurer is placed in a situation of conflict. The insurer's financial self-interest will be served if resolution of the dispute is moved to the

⁹² See *supra* note 6.

⁹³ Cf. *Voorhees v. Preferred Mut. Ins. Co.*, 588 A.2d 417 (N.J. Super. Ct. App. Div. 1991):

We do not read *Burd v. Sussex Mutual Insurance Co.* as requiring a hearing to determine whether Voorhees' acts were intentional or only reckless or negligent. Our Supreme Court in *Burd* said that in the event the insurer declines to defend its insured because of a perceived conflict and a judgment is entered, "the carrier may be heard upon the coverage issue in a proceeding upon the policy" and it "will have to reimburse the insured for the cost of the defense if the tort judgment is held to be within the covenant to pay." We need not delve into the question concerning what type of hearing was contemplated by the Court. Here, the Sisto suit was settled and no judgment was entered against the insured. Based on the small amount of the settlement, Voorhees can fairly argue that Sisto's claims, which encompassed both intentional and reckless or negligent conduct, were "wholly defeated." In that situation the insurer "may fairly be required to reimburse the insured for the cost of the successful defense even though the [insurer] would not have had to pay the judgment if the case had gone against the insured on a finding of intentional injury."

Id. at 424 (alteration in original) (citations omitted) (quoting *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7 (N.J. 1970)).

⁹⁴ Alternatively, the claimant may seek to satisfy the judgment by garnishing the insurance policy. In either case, since the insurer did not breach a duty to defend the insured, the insurer is allowed to litigate whether it has an obligation (debt) to the insured that may be garnished.

noncovered claims. This directing of the case will, if successful, operate to avoid the insurer's duty to indemnify for losses. Thus, the problem posed by *Gray* presents inherent conflicts between insurer and insured under either of the two possible alternatives the court had available.

The *Gray* resolution of the dilemma is justifiable when one examines the practical responses to each situation. In the first situation, where the insured bears the cost of defense, reasonable insureds and claimants would seek to reduce their immediate litigation costs by casting the judgment or settlement in terms that expose the insurer to its maximum obligation to indemnify. The insured is motivated to settle for reasons of economic survival; even if she is victorious, the cost of defense may result in a Pyrrhic victory. The claimant is motivated to settle because conclusion of the litigation advances the timetable for the real business at hand—collecting from the insurer. The strength of this tendency is inversely proportional to the insured's ability to respond financially to the claimant's injuries and directly proportional to the insured's ability to assume the costs of the defense.

Keep in mind that we are dealing with a category of cases where the coverage claim is suspect. If the coverage claim were strong, an economically rational insurer would in self-interest assume the defense.⁹⁵ Moreover, the insured's resources relative to the size of the claim, or policy limits, or both, is often small. Thus, as a practical matter, litigation against the insured is economically unappealing. My intuitive assumption is that in many cases of this type the net result would be a negotiated settlement between the claimant and the insured that would present the claimant with the right to look to the insurer for compensation.

The consequences of this result would be several. First, the court would now have to address in two lawsuits what would otherwise be resolved in one lawsuit. Second, unless the insured could be said to have some affirmative obligation to the insurer not to prejudice the interests of the insurer by entering into the settlement, the insurer could not complain of the insured's conduct. While I recognize that arguments could be made that the

⁹⁵ It is beyond the scope of this Article to address the question whether imposing cost-internalization on the insurer is economically wise from the viewpoint of efficiency. Similarly, whether it is fair depends on the definition of fairness one begins with. See generally KENNETH S. ABRAHAM, *DISTRIBUTING RISK* 8-30 (1986) (discussing economic efficiency and fair risk distribution as purposes of insurance law).

insured cannot prejudice the insurer's position, those arguments depend on the settlement being binding on the insurer. However, the insurer is bound only by a judgment or settlement entered in its absence between the claimant and the insured when the insurer has breached its duty to defend,⁹⁶ which has not occurred under this alternative. Thus, the insurer would be able to litigate the underlying claim to determine if the claim was within coverage. Moreover, if the insurer lost the coverage issue, it might be necessary to determine the scope of coverage available. This might require relitigation of the claimant's action both as to liability and damages.⁹⁷ The result of all of this is that the insurer's costs of defense would not be avoided, only delayed.⁹⁸

Under the approach adopted in *Gray*, the situation is different. The interests of the claimant and the insurer are unlikely to be aligned in any significant number of cases. While both the claimant and the insurer wish to reduce litigation costs, here their greater interests are not aligned but opposed. The claimant secures no "net" benefit from reducing the insurer's litigation

⁹⁶ See *Geddes & Smith v. St. Paul Mercury Indem. Co.*, 334 P.2d 881, 883 (Cal. 1959); *Ford v. Providence Wash. Ins. Co.*, 311 P.2d 930, 933 (Cal. Ct. App. 1957). This rule is based on the doctrine of "privity" arising out of the insurer's right to control the defense. Although in breach of duty to defend cases the fact of control does not arise, courts hold the insurer bound under principles of collateral estoppel. To hold otherwise would allow the insurer who breaches the duty to defend to be situationally better off than the insurer who complies with its defense obligations and assumes control of the defense of the insured.

⁹⁷ As a general rule, "[w]hen an insurer declines coverage . . . an insured may settle rather than proceed to trial." *Luria Bros. & Co. v. Alliance Assurance Co.*, 780 F.2d 1082, 1091 (2d Cir. 1986). See generally 7C APPLEMAN, *supra* note 1, § 4714 (discussing settlement by insured). Such conduct does not breach the insured's duty to cooperate. If the insurer's declination of coverage constituted a breach, however, the insurer is precluded from contesting the amount of the settlement, at least absent a showing of fraud, collusion, or bad faith on the part of the insured. See *Chaussee v. Maryland Casualty Co.*, 803 P.2d 1339, 1342-44 (Wash. Ct. App.), *modified*, 812 P.2d 487 (Wash. Ct. App. 1991); *Hyatt Corp. v. Occidental Fire & Casualty Co. of N.C.*, 801 S.W.2d 382, 388 (Mo. Ct. App. 1990). Whether the courts would apply this rule in the hypothetical situation where the insurer is given the *right* to litigate coverage based on an established record is problematic. Barring relitigation of the underlying claim would tend to penalize insurers who exercised their rights and would thus be inconsistent with the right.

⁹⁸ See, e.g., *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7 (N.J. 1970); see also *supra* notes 6, 48-52 and accompanying text (discussing *Burd*).

costs; indeed, the claimant's true leverage against the insurer is to present a credible, yet ethically permissible, threat that the insurer's litigation costs will exceed the true value of the duty to indemnify,⁹⁹ so as to put the insurer to a choice about how it should respond to the claim. The consequences of this is that it is unlikely the insurer will be able to enter into a settlement with the claimant without making some payment.¹⁰⁰ If the insurer does so, the claim will be discharged. If the insurer is unable to secure an agreement to discharge the claim, the insurer then continues with the defense of the insured. In this situation, the duty to defend is neither delayed nor avoided. Thus, a different decision in *Gray* would not have necessarily saved insurers any money. Actually, a different decision in *Gray* would have resulted, long term, in marked disadvantages to insurers since they would have lost their ability to control the resolution of the underlying claim and would have to defend against larger settlements and judgments than

⁹⁹ This would be the value the insurer placed on the claimant's claim, discounted to present value. If it is less than the present value of the insurer's litigation costs, which here include anticipated future settlement or judgment expenses, it is economically more prudent for the insurer to settle than litigate. See, e.g., Werner Z. Hirsch, *Reducing Law's Uncertainty And Complexity*, 21 UCLA L. REV. 1233 (1974):

What brings transactors into court in a world of uncertainty and what is the optimal frequency of cases? Rational private parties go to court when each side believes that its expected benefits exceed expected private costs. This can occur for two reasons: (a) each side has a different subjective probability of winning and estimate of award; or (b) the costs of bargaining are greater than the private costs of going to court. The first situation seems to be the more common. If the parties were to agree on the probability of winning and on the award, then the sum of the expected benefits for each side will equal the amount of the award minus the expected private costs. By settling out of court they can divide between themselves the saving of the private costs that would have been incurred. It is only when the expected benefits for each side exceed the award plus private costs that a case will actually go to court.

Id. at 1237 (footnote omitted).

¹⁰⁰ The insurer that assumes "control" of the defense does assume affirmative duties toward the insured. Thus, even if it were economically advantageous and possible to compromise the claim at the insured's expense, the insurer would be legally precluded from doing so. The presence of defense counsel also tempers the insurer's self-interest in manipulating the defense for its benefit. See *infra* note 111 and accompanying text.

might be entered were insurers, who are experienced litigators, in control of the defense.¹⁰¹

Placing the duty to defend on insurers in situations such as evidenced by the *Gray* potentiality test thus advances several public policies. First, it reduces the total number of cases filed as a result of each dispute between a claimant and an insured. While claimants would no doubt drop some cases were insurers not immediately brought into the litigation, that figure could be dwarfed by the greater number of collection suits that would be filed after each claimant settled or adjudicated the dispute with the insured, satisfied the "no action" clause of the insurance policy, and then looked to the insurer for payment of the settlement or judgment. Second, the *Gray* rule speeds the payment of monies to claimants. Compensation of those injured has become an increasingly important, if not dominant, purpose underlying judicial treatment of liability insurance policies.¹⁰² This pro-compensation policy is a fundamental reason for the potentiality test. Courts want insurers to buy peace by funding settlements; otherwise, the extra-contractual sanction imposed in many jurisdictions for wrongful denial of the defense serves no useful purpose.

Courts commonly hold that an insurer who wrongfully declines the tender of the defense of potentially covered claims must indemnify the insured who effects a good faith settlement, even though the claims asserted are not covered.¹⁰³ Yet an insurer

¹⁰¹ There is some empirical evidence that experienced litigants can exploit the general risk aversion of occasional litigants. See HOWARD RAIFFA, *THE ART AND SCIENCE OF NEGOTIATION* 76-77 (1982); see also Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1137-39 (1990).

¹⁰² See *Fageol Truck & Coach Co. v. Pacific Indem. Co.*, 117 P.2d 661, 669 (Cal. 1941) (stating that if semantically possible, the insurance contract will be construed so as to achieve its objective of securing indemnity to the insured for the losses to which the insurance relates). So as not to overstate the point, in general, such statements occur in the context of automobile liability insurance coverage disputes and against a backdrop of state "financial responsibility laws" designed to assure victim compensation. See, e.g., *State Farm Fire & Casualty Co. v. Tringali*, 686 F.2d 821 (9th Cir. 1982) (applying Hawaiian law); *Barrera v. State Farm Mut. Auto. Ins. Co.*, 456 P.2d 674 (Cal. 1969). Yet similar sentiments can be found in nonautomobile insurance contexts. See *Keene Corp. v. Insurance Co. of N. Am.*, 667 F.2d 1034, 1041 (D.C. Cir. 1981) ("In construing the policies' coverage of liability for asbestos-related diseases, our objective must be to give effect to the policies' dominant purpose of indemnity") (citations omitted), *cert. denied*, 455 U.S. 1007 (1982).

¹⁰³ See *supra* note 10 and accompanying text (discussing duty to settle).

who accepts the tender does not appear to have an affirmative duty to advance all or part of policy limits to settle noncovered claims. Why expose an insurer to extra-contractual liability unless the desire is to encourage insurers to accept tenders and thereafter act in an economically rational manner by settling, buying peace for themselves and their insureds, and providing compensation for claimants? The approach can be justified only as imposing on insurers the requirement that in making the decision whether to accept an insured's tender of the defense, the insurer must consider both the benefits and costs of its decision.

The *Gray* potentiality test thus forces an insurer to internalize both the costs and benefits of its decision whether to accept the defense in the same manner courts force insurers to internalize the costs and benefits of accepting or rejecting settlement demands within policy limits in third party cases.¹⁰⁴ A similar mandatory internalization rule applies in first party insurance disputes over rights to benefits.¹⁰⁵ Jurisdictions that have rejected *Gray* and impose the risk of noncoverage on the insured¹⁰⁶ have not explained why the duty to defend is not subject to the same cost-internalization principles courts have imposed on insurers in duty to pay¹⁰⁷ and duty to settle cases.¹⁰⁸ Ironically, some jurisdictions do not require insurers to internalize the costs of a potential breach of the duty to pay or the duty to settle but do require the insurer to internalize the costs of a potential breach of the duty to defend.¹⁰⁹

¹⁰⁴ The most common formulation of the insurer's duty in considering a within policy limits settlement offer is that the insurer must evaluate the offer as if there were no policy limits and the insurer would be solely responsible if it rejected the offer and an excess policy limits judgment were rendered. See Syverud, *supra* note 101, at 1122-23.

¹⁰⁵ Insurers in first party disputes are sanctioned if they fail to give at least equal consideration to the insured's interest as to their own interests. See Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1036-37 (Cal. 1973).

¹⁰⁶ See, e.g., Thornton v. Paul, 384 N.E.2d 335 (Ill. 1979); Burd v. Sussex Mut. Ins. Co., 267 A.2d 7 (N.J. 1970).

¹⁰⁷ See, e.g., Gruenberg, 510 P.2d 1032.

¹⁰⁸ See, e.g., Johansen v. California State Auto. Ass'n Inter-Ins. Bureau, 538 P.2d 744 (Cal. 1975).

¹⁰⁹ Compare Kewin v. Massachusetts Mut. Life Ins. Co., 295 N.W.2d 50 (Mich. 1980) (holding that "bad faith" breach of insurer's duty to pay does not give rise to extra-contractual damages) with Raska v. Farm Bureau Mut. Ins. Co., 314 N.W.2d 440 (Mich. 1982) (stating that an insurer must defend where an insured has a reasonable expectation that insurer will defend if a covered claim will potentially be asserted).

While the *Gray* rule no doubt results in insurers paying some claimants who do not have claims within coverage, the control that insurers exercise over the defense means that their aggregate exposure across all claims may be less than if those claims were determined in the insurers' absence. Undoubtedly, insurers would win some proportion of the second-wave collection suits by demonstrating that the claims underlying the settlement or judgment were not covered. I simply have little confidence that the number would be large enough to overcome the substantially higher settlements and judgments, negotiated in the insurer's absence, that would form the basis of the successful collection actions. Insurers do not have a history of success in litigating claims against injured victims when the insurer is a named party.¹¹⁰

Now, I confess that these views are not based on empirical evidence. No studies that I am aware of would allow comparison of the alternative ways to resolve the duty to defend problem. Perhaps insurers would be more successful in defending second-wave lawsuits than I believe they would be. Perhaps fewer first-wave lawsuits would be pursued by claimants if the insurer could successfully absent itself from the initial proceeding. Nonetheless, I believe that these views are intuitively sound, and in the absence of credible evidence to the contrary, support the *Gray* decision as one based on public policy in favor of conserving judicial resources by preventing multiple litigation and encouraging the prompt compensation of injured claimants.

The *Gray* test also results in a tempering of the conflict that is frequently encountered in cases of coverage disputes. As noted earlier, in such cases the interests of the insurer and the insured are adverse because each, for its own economic reasons, wishes to shift as much of any ultimate judgment as possible onto the lap of the other. Notwithstanding the coverage dispute, the *Gray* interpretation of the duty to defend requires the insurer to furnish counsel to represent the insured in defense of the underlying claim, albeit usually under a reservation of the right to contest coverage.¹¹¹ Nonetheless, the presence of counsel makes it more

¹¹⁰ This no doubt accounts for the continued popularity of the "loan receipt" and other devices whereby an insurer seeks to prevent the jury from discovering that it is the real party in interest. See, e.g., KEETON & WIDISS, *supra* note 1, § 3.10(c)(1), at 240-42.

¹¹¹ Appointment of counsel for the insured is one of the obligations assumed under the duty to defend. See *Merritt v. Reserve Ins. Co.*, 110 Cal.

difficult for the insurer to advance its interests at the expense of the insured. Modern opinion is uniform that appointed defense counsel owes primary allegiance and loyalty to the insured, not to the insurer.¹¹² And while occasional lapses of this obligation are noted in appellate opinions,¹¹³ one assumes, as one must, that attorneys will conform their conduct to the ethical rules of the profession.

CONCLUSION

As is so often the case when one addresses issues involving the relationship between insurer and insured with respect to obligations and rights created by the insurance contract, the rules articulated owe much of their force and shape to hidden, but deeply-rooted, forces of public policy, not the visible general law of contracts. Such is the case with the insurer's duty to defend. Judicial construction of liability insurance contracts has transformed those contracts significantly so that in many instances the insured has effectively purchased litigation insurance. Given the monetary costs of obtaining legal assistance, this is no small matter.

I have tried in this Article to explain and justify the accommodation proposed in *Gray v. Zurich Insurance Co.* The *Gray* court

Rptr. 511, 526-27 (Ct. App. 1973). Questions of the loyalty of defense counsel selected by the insurer arise when a conflict of interest exists between the insurer and the insured, normally involving the question of coverage. Courts consistently recognize the right of the insured to independent—here, conflict-free—counsel. *See, e.g.,* New York State Urban Dev. Corp. v. VSL Corp., 738 F.2d 61, 65 (2d Cir. 1984); Parsons v. Continental Nat'l Am. Group, 550 P.2d 94, 98-99 (Ariz. 1976). Implementation of that right has not, however, been consistent. *Compare* New York State Urban Dev. Corp. v. VSL Corp., *supra* (holding that, in case of conflict, insurer may select independent counsel to be compensated by insurer, if so provided by the language of the policy) *with* Executive Aviation, Inc. v. National Ins. Underwriters, 94 Cal. Rptr. 347, 354 (Ct. App. 1971) (holding that where insurer offers defense under reservation of rights and conflict exists, insured has absolute right to select independent counsel to be compensated by insurer).

¹¹² *See* *Betts v. Allstate Ins. Co.*, 201 Cal. Rptr. 528, 545 (Ct. App. 1984); *see also* MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 5-17 n.23 (1980); MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.8(f)(2) (1990); Los Angeles County Bar Ass'n Comm. on Legal Ethics, Op. 439 (1986); New York State Bar Ass'n Comm. on Prof. Ethics, Op. 73 (1968); District of Columbia Bar Legal Ethics Comm., Op. 173 (1986). *See generally* Holmes, *supra* note 47.

¹¹³ *See, e.g., Betts*, 201 Cal. Rptr. at 545-46.

intuitively reached a good accommodation. The court's reasoning was, however, incomplete. I have, I hope, supplied correct and more complete reasons for continuing with the accommodation achieved by *Gray*.

