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CASE LAW DEVELOPMENTS ADDRESSING THE CONSEQUENCES OF A LIABILITY INSURER'S BREACH OF ITS DUTY TO DEFEND

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Courts are sharply divided over whether liability insurers that breach their duty to defend insureds should be permitted to raise policy exclusions in defense of subsequently commenced litigation brought by their insureds.¹ Difficulty in

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¹ *Compare* *Sauer v. Home Indem. Co.*, 841 P.2d 176, 184 (Alaska 1992) (“[A]n insurance company which wrongfully refuses to defend is liable for the judgment which ensues even though the facts may ultimately demonstrate that no indemnity is due.”); *Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co.*, 230 A.2d 21, 26 (Conn. 1967) (“The defendant, after breaking the contract by its unqualified refusal to defend, should not thereafter be permitted to seek the protection of that contract in avoidance of its indemnity provisions.”); *Emp’rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134-35 (Ill. 1999) (insurer that refuses to defend insured without defending under a reservation of rights or seeking a declaratory judgment that there is no coverage, and is later found to have wrongfully denied coverage, is estopped from raising policy defenses to coverage); *Miss. Ins. Guar. Ass’n v. Byars*, 614 So. 2d 959, 964 (Miss. 1993) (“[W]hen an insurer breaches its duty to defend an insured, it is liable and bound by any settlement agreements made by the insured as a result of this breach.”); *Newman v. Scottsdale Ins. Co.*, 301 P.3d 348, 359 (Mont. 2013) (“If an insurer unjustifiably refuses to defend a claim, that insurer is estopped from denying coverage.”); *Pulte Home Corp. v. Am. S. Ins. Co.*, 647 S.E.2d 614, 617 (N.C. Ct. App. 2007) (insurer that refuses to defend its insured without justification is estopped from denying coverage), *and* *Radke v. Fireman’s Fund Ins. Co.*, 577 N.W.2d 366,

resolving the thorny issue of what remedy should be imposed on an insurer for failing to provide an insured with a defense is evident in the two decisions of the New York State Court of Appeals in the case of *K2 Investment Group, LLC v. American Guarantee Liability & Insurance Co.*² Although the initial opinion barred the carrier from raising exclusions, it was followed within eight months by a reversal upon reargument on the ground that, while there was support for its original decision, *stare decisis* should have been followed and led to the opposite result. In May 2014, taking a position contrary to New York's approach on reargument, the American Law Institute passed a *Principles of the Law of Liability Insurance Tentative Draft No. 2*, recommending that carriers that breach their duty to defend be precluded from contesting coverage in any suit against them for indemnification.³

371 (Wis. Ct. App. 1998) ("Because Fireman's Fund breached its duty to defend, it may not now challenge or otherwise litigate the coverage issues."), *with, e.g.*, *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 193 F.3d 966, 970 (8th Cir. 1999) (applying Missouri law and holding that an insurer liable for full amount of settlement, including the portion related to uncovered claims, would award the policyholder a windfall); *Flannery v. Allstate Ins. Co.*, 49 F. Supp. 2d 1223, 1229 (D. Colo. 1999) (applying Colorado law and stating "[A]n insurer is not precluded from contesting coverage when it has breached its obligation to defend its insured, even if such breach was in bad faith."); *Ala. Hosp. Ass'n Trust v. Mut. Assurance Soc'y*, 538 So. 2d 1209, 1216 (Ala. 1989) (failure of insurer to defend claim against insured does not bar insurer from relying on exclusions on the issue of coverage); *Hirst v. St. Paul Fire & Marine Ins. Co.*, 683 P.2d 440, 447 (Idaho Ct. App. 1984) (declining to impose estoppel against insurer for breach of contractual duty to defend); *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 921 (Mass. 1993) ("A failure to defend does not bar an insurer from contesting its indemnity obligation."); *Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford*, 477 N.E.2d 441, 444 (N.Y. 1985) ("By holding the insurer liable to indemnify on the mere 'possibility' of coverage perceived from the face of the complaint—the standard applicable to the duty to defend—the [lower] court has enlarged the bargained-for coverage as a penalty for breach of the duty to defend, and this it cannot do.").

² *K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co.*, 993 N.E.2d 1249 (N.Y. 2013), *rev'd in part on reargument*, 6 N.E.3d 1117 (N.Y. 2014). Haskel and Zlotnick represented the plaintiffs in the *K2* case.

³ PRINCIPLES OF THE LAW OF LIABILITY INSURANCE § 21(1) (AM. LAW INST., Tentative Draft No. 2, March 26, 2014) ("A liability insurer that breaches the duty to defend a claim loses . . . the right to contest coverage for the claim."). The American Law Institute subsequently announced that it would convert

In pursuit of a greater understanding of this controversial subject, this article will: (1) explore the contract principles and public policy considerations that are implicated by an insurer's breach of its defense duty; (2) consider recent case law addressing relevant issues; and (3) recommend a comprehensive approach that accommodates competing interests. Ultimately, the author concludes that in most circumstances an insurer that wrongfully disclaims its duty to defend should be precluded from raising defenses as to coverage in an action to indemnify the insured for monies paid out by the insured.

I.

The circumstances that are common to all cases that are the subject of this article include: a liability insurance policy with a policy provision ("Defense Clause") requiring defense of the insured against claims for indemnity arising out of acts and omissions constituting a claim as defined by the policy ("Defense Duty"); and the carrier's violation of the Defense Clause ("Insurer's Breach") by declining to defend the insured in the litigation asserting such claim ("Underlying Action"). In each case, the Insurer's Breach leads to the application of contract jurisprudence to determine the nature of the breach and the appropriate remedy. The starting point is the wording of the policy, particularly the language constituting the Defense Duty.

Liability insurance policies define the term "claim" as encompassing allegations that, if true, would render the insured liable to the claimant for acts and omissions that fall within the policy's coverage ("Basic Coverage"). Where the facts establish that a claim falls within the policy's Basic Coverage, the carrier must indemnify the insured unless a policy exclusion ("Exclu-

the "Principles of the Law of Liability Insurance" project into a "Restatement of the Law of Liability Insurance" project, meaning that it now should reflect the law in the majority of jurisdictions. It is likely that this section will be revised, given that it presently reflects what is acknowledged to be a minority rule. However, this article takes the position that the minority rule, reflected in the previously approved "Principles," is the correct one.

sion”), which is a defined exception to Basic Coverage, is proven by the carrier.⁴

Typically, Defense Clauses impose all responsibility for defense under a liability policy of insurance, upon the insurer, which is vested with control over the handling of the claim’s defense. The insurer’s dominance is practical because insurers are presumptively better experienced in dealing with the defense of claims than their insureds. In discharging its Defense Duty, a carrier satisfies the insured’s expectation that the carrier will provide protection against claims, whether meritorious or not, which is what the Defense Clause routinely requires.⁵ The standard Defense Clause also expressly binds the insured to cooperate with the insurer in such defense, which is consistent with the best interests of both the insurer and the insured.⁶ The latter is obviously benefitted through the insurer’s assumption of the responsibility for the defense. Often lacking the expertise or resources to address any claim raised against it, an insured is clearly favored by a carrier’s honoring its Defense Duty. The insurer, too, may be served through its control and oversight of the defense of any claim that potentially results in an insurer’s obligation to indemnify the insured for claims falling within Basic Coverage. Because of the insurer’s privity with its insured on issues resolved in the Underlying Action, the insurer will be collaterally estopped from raising defenses that were or could have been asserted in the Underlying Action.⁷ Even when the carrier satisfies its Defense Duty, the possibility that the indemnity obligation will be triggered will exist, but playing a lead role in the defense of the claim can enable a carrier to reduce suboptimal outcomes brought about, for example, by inadequate legal representation or collusion be-

⁴ See, e.g., *Consol. Edison Co. of New York, Inc. v. Allstate Ins. Co.*, 774 N.E.2d 687, 692 (N.Y. 2002).

⁵ See, e.g., *Cont’l Cas. Co. v. Rapid-Am. Corp.*, 609 N.E.2d 506, 508 (N.Y. 1993) (policy imposing on insurer duty to defend any suit against the insured seeking damages payable under the policies “even if any of the allegations of the suit are groundless, false or fraudulent”).

⁶ However, economic reasons may encourage an insurer to ignore its Defense Duty to its insured, depending upon the consequences of such refusal. See discussion *infra* pp. 221-22.

⁷ See, e.g., *Rucaj v. Progressive Ins. Co.*, 797 N.Y.S.2d 79, 82 (App. Div. 2005); *Matychak v. Sec. Mut. Ins. Co.*, 581 N.Y.S.2d 453, 455 (App. Div. 1992).

tween the insured and the party prosecuting the Underlying Action.

Consistent with the purpose of vesting the insurer with control over the defense of claims, Defense Clauses are broadly written, and commonly provide the insurer with authority over material aspects of the defense, including the selection of counsel and settlement.⁸ Courts have construed Defense Clauses expansively, imposing upon the insurer liability for failure to hire capable defense counsel,⁹ conscientiously evaluate claims,¹⁰ retain appropriate experts,¹¹ and actively supervise the defense.¹² Decisions have interpreted Defense Clauses to require the insurer to provide enumerated services competently, along with others necessary to implement the Defense Duty meaningfully.¹³

A large body of decisional law extends the Defense Duty to any claim that might potentially fall within the policy based upon the pleadings in the Underlying Action.¹⁴ Although they

⁸ See *St. Paul Mercury Ins. Co. v. Pa. Cas. Co.*, 642 F. Supp. 180, 186 (D. Wyo. 1986) (quoting insurance policy stating that “[t]he company may make such investigation and settlement of any claim or suit as it deems expedient” and “[t]he company shall have sole and final authority to select and retain counsel for the defense of any insured pursuant to the company’s obligation under this policy”).

⁹ See *Sierra Pac. Indus. v. Am. States Ins. Co.*, No. 2:11-cv-00346-MCE-JFM, 2011 WL 2935878, at *3 (E.D. Cal. July 8, 2011) (“The duty to defend requires that the carrier provide competent counsel, qualified to defend the insured in the particular matter at issue.”).

¹⁰ See *Fredericks v. Home Indem. Co.*, 474 N.Y.S.2d 870, 873 (App. Div. 1984) (holding insurer acted “in bad faith in conducting a defense when on the eve of trial it was still unaware of the precise amount of coverage available”).

¹¹ See *Roehl Transp., Inc. v. Liberty Mut. Ins. Co.*, 784 N.W.2d 542, 567 (Wis. 2010) (upholding jury finding of bad faith, based in part on insurer’s failure to retain experts, including an accident reconstructionist, who could have provided evidence limiting the insured’s liability to the injured party).

¹² See *Avondale Indus., Inc. v. Travelers Indem. Co.*, 123 F.R.D. 80, 83 (S.D.N.Y. 1988) (duty to defend involves “taking on the burden of decision-making regarding litigation strategy” and “effective management of litigation in a multi-front liability war”), *aff’d*, 887 F.2d 1200 (2d Cir. 1989).

¹³ See *Murphy v. Hopkins*, 4 N.W.2d 801, 805 (S.D. 1942) (holding duty to defend included obligation to pay expenses incurred in procuring necessary attendance of witnesses).

¹⁴ *E.g.*, *Miller v. Elite Ins. Co.*, 161 Cal. Rptr. 322, 329 (Ct. App. 1980); *Penn-Am. Ins. Co. v. Disabled Am. Veterans, Inc.*, 490 S.E.2d 374, 376 (Ga. 1997); *Farmers Auto. Ins. Ass’n v. Danner*, 967 N.E.2d 836, 842 (Ill. App. Ct. 2012);

could have, many such decisions have not discussed the actual language of Defense Clauses in finding a Defense Duty, which suggests that the parameters of the Defense Duty arise from public policy considerations, not simply contract language, and are now part of *stare decisis*.¹⁵ In contrast, the narrower duty to indemnify (“Indemnity Duty”) is limited to the payment of claims that actually fall within the policy, as established by the facts determined in the Underlying Action.¹⁶ This distinction has led many carriers, even while they are defending their insureds, to: (i) reserve their rights to raise exclusions to claims; and/or (ii) commence declaratory judgment actions seeking judicial determinations as to whether any policy exclusion relieves the carriers of responsibility for the claims. The pursuit of one of these two options is judicially favored (“Favored Insurers Approach”).¹⁷ In contrast, an insurer’s refusal to defend its insured in the Underlying Action on the basis of the applicability of an exclusion, before there is a judicial determination of the validity of the exclusion, is a disfavored approach (“Disfavored Insurers Approach”)¹⁸ (collectively, Favored Insurers Approach and Disfavored

Frontier Insulation Contractors v. Merchs. Mut. Ins. Co., 690 N.E.2d 866, 868 (N.Y. 1997).

¹⁵ See Northbrook Prop. & Cas. Co. v. Transp. Joint Agreement, 741 N.E.2d 253, 254 (Ill. 2000) (stating, “[i]f the underlying complaints allege facts within or potentially within policy coverage, the insurer is obliged to defend its insured even if the allegations are groundless, false, or fraudulent,” without referencing policy language on the duty to defend).

¹⁶ E.g., Buss v. Superior Court, 939 P.2d 766, 773 (Cal. 1997); Burlington N. & Santa Fe Ry. Co. v. Nat’l Union Fire Ins. Co. of Pittsburgh, PA, 334 S.W.3d 217, 219 (Tex. 2011); see Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford, 477 N.E.2d 441, 444 (N.Y. 1985) (“[T]he duty to pay is measured by the actual basis for the insured’s liability to a third person.”).

¹⁷ See Lang v. Hanover Ins. Co., 820 N.E.2d 855, 858-59 (N.Y. 2004) (“[W]e note that an insurance company that disclaims in a situation where coverage may be arguable is well advised to seek a declaratory judgment concerning the duty to defend or indemnify the purported insured.”).

¹⁸ See *id.* at 859 (“If [the insurance company] disclaims and declines to defend in the underlying lawsuit without doing so, it takes the risk that the injured party will obtain a judgment against the purported insured and then seek payment pursuant to [New York] Insurance Law § 3420. Under those circumstances, having chosen not to participate in the underlying lawsuit, the insurance carrier may litigate only the validity of its disclaimer and cannot challenge the liability or damages determination underlying the judgment.”).

Insurers Approach shall be referred to as an “Insurer Approach”).

Although the Favored Insurers Approach reduces the possibility of certain potentially adverse outcomes to both insurers and insureds, insurers, based on purely economic considerations, may choose to run the risk that they will lose part or all of their ability to defend a claim for indemnity for breach of their Defense Duty. Where an insurer is guided exclusively by profit motive, the Insurer Approach will be based on the carrier’s assessment of interrelated variables that bear upon the attendant risk that attaches to the carrier’s decision (“Insurer’s Approach Variables”). Among these are: (1) whether a claimant is likely to prevail against the insured in the Underlying Action on a cause of action that falls within Basic Coverage; (2) whether the pleading in the Underlying Action is based on allegations that, in whole or in part, fall within any exclusion; (3) the likelihood that the carrier will prevail in proving the applicability of its exclusion; (4) the cost of defending the Underlying Action; (5) the cost of obtaining a resolution of the validity of any of the exclusions; (6) the possibility the insured will not bring suit for Insurer’s Breach; (7) the cost to the insurer of defending an action, if brought by the insured for breach; and (8) the cost resulting from the resolution in the Underlying Action of issues against the insurer by reason of the insurer’s privity with the insured in the Underlying Action.¹⁹

Insurers guided solely by the desire to maximize profits will engage in an analysis in which Disfavored Insurers Approach Costs will be weighed against Favored Insurers Approach Costs. Putting aside additional adverse consequences imposed by any applicable jurisprudence for following Disfavored Insurers Approach, a Disfavored Insurers Approach will be followed if Disfavored Insurers Approach Costs are perceived to be less than Favored Insurers Approach Costs in any given case. No doubt on some level there will be an effort to

¹⁹ Here, items (1), (2), and (3) are Insurer’s Approach Variables that relate to the likely outcome of any litigation that implicates the exclusion directly or indirectly. Items (4) and (5) are associated with those expenses that follow a carrier’s following a Favored Insurers Approach (“Favored Insurers Approach Costs”). Items (6), (7), and (8) are variables that are associated with the pursuit of a Disfavored Insurers Approach (“Disfavored Insurers Approach Costs”).

quantify the possibility that an insured will commence suit for an Insurer's Breach. This possibility will be factored into the insurer's decision, *viz.*, the Disfavored Insurers Approach Costs will consider the costs that would be incurred if an insured pursued litigation for an Insurer's Breach. Where the Favored Insurers Approach Costs are equal to Disfavored Insurers Approach Costs, without taking account of item (6) above, profit-driven carriers will always choose a Disfavored Insurers Approach because of the significant likelihood that a number of insureds will not bring suit, resulting in a cost savings. In addition, Disfavored Insurers Approach Costs have the economic advantage of being deferred costs, while Favored Insurers Approach Costs are incurred at an earlier point in time.

Allan Windt observes that in the majority of jurisdictions, the carrier who abandons its insured can still assert an exclusion in a subsequently brought action against the carrier for Insurers Breach.²⁰ However, realizing the role that profit motive plays in leading to a decision that may adversely affect the contractual rights of insureds, a number of courts have rejected what the author shall refer to as the "Exclusion Survival Rule," which allows a carrier that has violated its Defense Duty to raise exclusions in subsequently commenced litigation against the insurer for indemnification.²¹ These courts prefer a touchstone which provides that an Insurer's Breach bars a carrier from raising policy exclusions (the "Exclusion Bar Rule").²²

²⁰ See generally 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4:37, at 4-296 to -302 (6th ed. 2013).

²¹ See, e.g., *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 193 F.3d 966, 970 (8th Cir. 1999) (applying Missouri law); *Flannery v. Allstate Ins. Co.*, 49 F. Supp. 2d 1223, 1229 (D. Colo. 1999) (applying Colorado law); *Ala. Hosp. Ass'n Trust v. Mut. Assurance Soc'y*, 538 So. 2d 1209, 1216 (Ala. 1989); *Hirst v. St. Paul Fire & Marine Ins. Co.*, 683 P.2d 440, 447 (Idaho Ct. App. 1984) (declining to impose estoppel against insurer for breach of contractual duty to defend); *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 921 (Mass. 1993); *Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford*, 477 N.E.2d 441, 444 (N.Y. 1985).

²² Illinois case law estops an insurer that has wrongfully disclaimed its duty to defend from raising *any* policy defenses to coverage. See, e.g., *Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134-35 (Ill. 1999). The Exclusion Bar Rule, barring the raising of exclusions, is somewhat narrower than Illinois's rule, in that it precludes only the application of policy exclusions, not other defenses to coverage.

When the Exclusion Bar Rule is followed, the costs to the Insurer of at least four items of the Insurer's Approach Variables, *viz.*, (3), (6), (7), and (8) are directly or indirectly increased, creating an incentive to follow a Favored Insurers Approach.

Although the Exclusion Bar Rule seems the minority approach, it appears to be gaining greater acceptance, particularly among legal scholars.²³ The question, however, remains thorny, as reflected in the recent vacillation of New York's Court of Appeals in the *K2* case, which at first applied the Exclusion Bar Rule,²⁴ but later followed the Exclusion Survival Rule.²⁵

In general, the reasoning supporting which of these two rules is followed falls into three categories: (1) contract law embodying the calculation of damages; (2) the judiciary's right to shape appropriate remedies for the violation of judicial constructs; and (3) public policy. As shall be seen, the proper choice between the Exclusion Bar Rule and the Exclusion Survival Rule requires a precise defining of relevant legal issues, followed by an application of law and public policy tailored to those issues. Ultimately, this author concludes the Exclusion Bar Rule, with some modifications, should be employed.

II.

A. *Contract Principles*

1. The Exclusion Survival Rule

Liability insurance policies are silent on the consequences of the abandonment of insureds prior to the determination of whether an exclusion applies,²⁶ inviting the applicability of contract jurisprudence to address this issue.

²³ See PRINCIPLES OF THE LAW OF LIABILITY INSURANCE § 21(1) (AM. LAW INST., Tentative Draft No. 2, March 26, 2014) ("A liability insurer that breaches the duty to defend a claim loses . . . the right to contest coverage for the claim.").

²⁴ See *K2 Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, 993 N.E.2d 1249, 1254 (N.Y. 2013), *rev'd in part on reargument*, 6 N.E.3d 1117 (N.Y. 2014).

²⁵ See *K2 Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, 6 N.E.3d 1117, 1120 (N.Y. 2014).

²⁶ It is safe to assume that if this were otherwise, the case law would address this circumstance.

Insurer advocates contend that the Exclusion Survival Rule is founded upon a well-recognized principle of compensatory damages that limits awards to redressing injury proximately caused by breach of contract (“Compensatory Damages Principle”). The Compensatory Damages Principle is intended to make whole the injured party for the resulting loss directly attributable to the breach, but nothing beyond, because compensatory damages are meant to place the injured party in the position he would have been in had the wrong not occurred.²⁷

The application of the Compensatory Damages Principle to a carrier’s breach of its Defense Duty limits damage awards to actual losses that are occasioned by the Insurer’s Breach. Because there is no coverage where an exclusion has been established, the Compensatory Damages Principle has been employed to avoid carrier indemnity obligations where the actual facts place the loss within the exclusion.²⁸ As explained by Allan Windt, when “a contract is breached, the injured party is entitled to receive what would have been obtained if there had been no breach; the injured party is not entitled to receive more.”²⁹

The Exclusion Survival Rule is premised upon the notion that there is no basis for treating an Insurer’s Breach of the Defense Duty any differently than a breach of a non-insurance contract. At the heart of holdings following the Exclusion Survival Rule³⁰ is the conviction that “[i]f an underlying claim ... is not within the coverage of an insurance policy, an insurer’s improper failure to defend that claim would not ordinarily be a cause of any payment that the insured made in settlement of that claim (or to satisfy a judgment based on that claim).”³¹ Going even further, some courts have held that imposing liabil-

²⁷ *E.g.*, Taylor v. Colo. State Bank of Denver, 440 P.2d 772, 774 (Colo. 1968); Billings Clinic v. Peat Marwick Main & Co., 797 P.2d 899, 913 (Mont. 1990).

²⁸ *See, e.g.*, Timberline Equip. Co. v. St. Paul Fire & Marine Ins. Co., 576 P.2d 1244, 1248 (Or. 1978).

²⁹ 1 ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4:37, at 4-298 (6th ed. 2013).

³⁰ *E.g.*, Hirst v. St. Paul Fire & Marine Ins. Co., 683 P.2d 440, 447 (Idaho Ct. App. 1984); Arceneaux v. Amstar Corp., 66 So. 3d 438, 452 (La. 2011); Elliott v. Hanover Ins. Co., 711 A.2d 1310, 1313 (Me. 1998); Polaroid Corp. v. Travelers Indem. Co., 610 N.E.2d 912, 921 (Mass. 1993).

³¹ *Polaroid Corp.*, 610 N.E.2d at 921.

ity on a carrier for an excluded claim on the basis of a breach of the Defense Duty would be tantamount to a rule of “automatic” indemnity.³² This argument against the Exclusion Bar Rule contends that depriving a breaching carrier of the right to raise exclusions in defense of the indemnity action would award a policyholder a “windfall in the form of greater insurance coverage than [the policyholder] would have obtained had the insurer defended the underlying case.”³³

An ancillary issue raised in favor of the Exclusion Survival Rule is that the Defense Duty is broader than the Indemnity Duty (“Defense-Indemnity Axiom”),³⁴ which is certainly true,³⁵ but the Defense-Indemnity Axiom actually highlights the breadth of the Defense Duty and invites consideration of whether there can be damages for its breach prior to a determination of an exclusion relieves the carrier of the Defense Duty.

2. The Exclusion Bar Rule

a. *The Exclusion Bar Rule and the Compensatory Damages Principle*

Although those courts that have followed the Exclusion Bar Rule have often cited factors that justify avoiding the application of the Compensatory Damages Principle,³⁶ the Exclu

³² *Id.* at 920-21.

³³ *Esicorp, Inc. v. Liberty Mut. Ins. Co.*, 193 F.3d 966, 970 (8th Cir. 1999) (applying Missouri law).

³⁴ *See Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford*, 477 N.E.2d 441, 444 (N.Y. 1984).

³⁵ *See id.*

³⁶ *See, e.g., Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 67 A.3d 961, 993 (Conn. 2013) (insurer that wrongfully refuses to defend may not seek the protection of [the insurance] contract in avoidance of its indemnity provisions); *Emp’rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134-35 (Ill. 1999) (insurer that wrongfully refuses to defend, without defending under a reservation of rights or seeking a declaratory judgment that there is no duty to defend, is estopped from raising policy defenses to coverage); *Radke v. Fireman’s Fund Ins. Co.*, 577 N.W.2d 366, 371 (Wis. Ct. App. 1998) (“When an insurer wrongfully refuses to defend on the grounds that a claim against its insured is not within the coverage of its policy, the insurer cannot later contest coverage, but is liable to the insured.”).

sion Bar Rule does not offend the Compensatory Damages Principle, provided the Compensatory Damages Principle is applied with careful attention to the timing of the Insurer's Breach. Recognition that the Exclusion Bar Rule and the Compensatory Damages Principle may peacefully coexist invites addressing the flawed assumption that if it is later determined that an exclusion is valid, there can be no harm for a carrier's failure to defend, because the claim was not covered in the first instance. The error underlying this contention is in its failure to consider the period prior to the time ("Pre-Exclusion Resolution") when there is a determination of the exclusion's validity ("Exclusion Resolution"), which is a period when defense is required.³⁷ Even if the insurer succeeds in proving that an exclusion relieves it of the duty to indemnify and defend an ongoing Underlying Action, any damage that occurs during the Pre-Exclusion Resolution period should be awarded to the insured given the Insurer's Breach of the Defense Duty. The subsequent establishment of the validity of the exclusion does not retroactively eliminate those damages, nor alter their nature, because the damages arise from the Insurer's Breach.

Up until the Exclusion Resolution, unless there is a judgment or an insured settlement in the Underlying Action, there would appear to be no damages for the Insurer Breach except for defense costs incurred by the insured. This common perception is reflected in the conclusion that an Insurer's Breach is "not ordinarily . . . a cause of any payment."³⁸ However, the events of a judgment against, or a settlement by, the insured raise the issue of whether, had the carrier defended the insured, the outcome would have been different, *viz.*, could the claim have been defeated if the carrier had honored its Pre-Exclusion Resolution Defense Duty.

The Compensatory Damages Principle is not violated by judicial recognition of the possibility that injury was done to the insured as a result of a Pre-Exclusion Resolution Insurer's Breach. By narrowing damages occasioned by the Insurer's Breach to those arising Pre-Exclusion Resolution ("Pre-

³⁷ As discussed above, the duty to defend is triggered by the allegations in the pleading and by any possibility that the claim may be within the policy's coverage.

³⁸ *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 921 (Mass. 1993).

Exclusion Resolution Insurer Breach Damages”), one of the obstacles argued against the Exclusion Bar Rule is avoided: the Compensatory Damages Principle is not sacrificed by recognition that a subsequently established exclusion is no defense to an award of damages actually caused by Insurer’s Breach of its Defense Duty. Remaining open is how to treat proximate cause and quantification of damages issues.³⁹

Generally, courts following the Exclusion Bar Rule have cited the well-established rule that contracting parties are entitled to the benefit of their bargain as provided in the policy. There is no question that the Defense Duty is part of the benefit of the bargain.⁴⁰ A significant component of insurance premiums is dedicated to claims defense, and, in light of applicable law, such defense is required up until Exclusion Resolution. This aspect of the Defense Duty is reflected in decisions requiring carriers to defend insureds if any question exists as to the applicability of an exclusion sought to be invoked by the carrier.⁴¹ No doubt aware of this feature of the Defense Duty, carriers, in pursuit of good business practices, calculate the cost of defense as part of the premium they charge. That part of the premium represents the carrier’s obligation to absorb defense costs incurred until there is an Exclusion Resolution only further supports the notion that Pre-Exclusion Resolution defense is part of the consideration the insured pays for in payment for the policy, and therefore the insured has every right to expect to be awarded damages for any Pre-Exclusion Resolution breach.

Furthermore, because carriers either collect, or have the opportunity to calculate and collect, premiums to address Pre-Exclusion Resolution defense costs, the consequences of an in-

³⁹ These questions will be discussed below. See *infra* pp. 233-34.

⁴⁰ See *BP Air Conditioning Corp. v. One Beacon Ins. Grp.*, 821 N.Y.S.2d 1, 6 (App. Div. 2006) (“[W]here a liability policy promises defense as well as indemnification, ‘litigation insurance’ – even where an eventual judgment against an insured may not be within the scope of coverage – is an integral part of the benefit of the insured’s bargain.”), *aff’d as modified*, 871 N.E.2d 1128 (N.Y. 2007).

⁴¹ See *Gibraltar Cas. Co. v. Sargent & Lundy*, 574 N.E.2d 664, 675 (Ill. App. Ct. 1990) (“If an exclusion clause is relied upon to deny coverage, its applicability must be clear and free from doubt at the time the insurer is requested to defend because any doubts as to coverage will be resolved in the insured’s favor.”).

surer's Pre-Exclusion Resolution Breach are not a windfall to the insured; to the contrary, the retention of such premiums without providing a defense would be a windfall to the carrier in the form of unwarranted costs savings ("Unwarranted Defense Costs Savings"). Intuitively, it would appear that Unwarranted Defense Costs Savings are significant. As noted above, any number of insureds who might have a claim for an Insurer's Breach will not pursue these claims for a variety of reasons, including financial inability.⁴² Regardless of the reason for the insured's failure to pursue an action against its carrier, the breaching insurer will realize significant cost avoidance. Although it would seem no study has been undertaken to ascertain the total Unwarranted Defense Costs Savings, regardless of the actual figure, Unwarranted Defense Costs Savings represents an unfair benefit to the carrier at the expense of the insured. In recognition of this inequity, courts have applied the Exclusion Bar Rule to provide carriers with an incentive to honor their Defense Duty by affording insureds this benefit of the bargain of their policy.⁴³

b. *Contract Principles and the Exclusion Bar Rule*

i. Traditional Contract Enforcement Consideration and the Application of the Compensatory Damages Principle

In addition to the argument that damage awards for a Pre-Exclusion Resolution Insurer's Breach of its defense duty are consistent with the Compensatory Damages Principle, traditional contract principles have been cited in support of the Exclusion Bar Rule.⁴⁴ The central role that the Defense Duty

⁴² Although there appears to be no study that explores this issue, this circumstance that insureds will not pursue breaches of the Defense Duty is suggested by statutes such as New York Insurance L. § 3420, which permits a direct cause of action by the plaintiff in the underlying lawsuit against the carrier. The frequency of the employment of this statute, at least indirectly, suggests that insureds have less of an incentive to pursue claims in their own right than do third party plaintiffs, whether due to financial inability to do so, lack of knowledge, lack of motivation, or a combination of these factors.

⁴³ See *BP Air Conditioning Corp.*, 821 N.Y.S.2d at 6.

⁴⁴ See *Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co.*, 230 A.2d 21, 26 (Conn. 1967) ("The defendant, after breaking the contract by its unqualified refusal to defend, should not thereafter be permitted to seek the

plays in insurance policies has long been recognized. In the case of *St. Louis Dressed Beef & Provision Co. v. Maryland Casualty Co.*,⁴⁵ Justice Oliver Wendell Holmes opined that an insurer's refusal to defend a policyholder without justification "cut at the very root of the mutual obligation" between the insurer and its policyholder.⁴⁶

Insofar as the Defense Duty involves the provision of services, its breach implicates well-settled contract jurisprudence that permits the granting of exceptional relief⁴⁷ against the party dishonoring its promise to perform, where the services involved are extraordinary. While the performance of services under the Defense Clause may not be unique, those to be provided are, unquestionably, special. In the discharge of its Defense Duty, a carrier can take advantage of its experience in the defending of similar claims, its statistical analyses of claims data, and its special expertise arising from its background and special skills that provide the carrier with insight into the best defense approach. These advantages are accompanied by the insurer's control of an apparatus that is suited for the defense of such claims and the carrier's financial ability to retain competent outside counsel to defend litigation against the insured.

protection of that contract in avoidance of its indemnity provisions."); *Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1135 (Ill. 1999) ("[A]n insurer's duty to defend under a liability insurance policy is so fundamental an obligation that a breach of that duty constitutes a repudiation of the contract.").

⁴⁵ *St. Louis Dressed Beef & Provision Co. v. Maryland Cas. Co.*, 201 U.S. 173 (1906).

⁴⁶ *Id.* at 181.

⁴⁷ For example, where rendering of services is the subject of a contract, the party promising their performance may be required by injunction to fulfill the contractual obligation. Insurance carriers are the subject of such injunctions issued in exercise of courts' equity powers. See *Emons Indus., Inc. v. Liberty Mut. Ins. Co.*, 749 F. Supp. 1289, 1291-99 (S.D.N.Y. 1990) (imposing preliminary injunction requiring, *inter alia*, that insurer continue to pay insured's defense costs). Clearly courts recognize the need for awarding more expansive remedies in cases including the breach of the promise of services. See *Am. Broad. Co. v. Wolf*, 420 N.E.2d 363, 367 (N.Y. 1981) ("[W]here an employee refuses to render services to an employer in violation of an existing contract, and the services are unique or extraordinary, an injunction may issue to prevent the employee from furnishing those services to another person for the duration of the contract.").

Furthermore, in the defense of claims, the superior position of the carrier in relation to the insured is a circumstance that results in the insured's dependency upon the insurer. While sometimes stopping short of classifying the relationship of an insurer and an insured as fiduciary in nature,⁴⁸ decisions have noted such dependency, leading to treatment of certain aspects of the insurer/insured relationship as similar to that arising between principal and agent.⁴⁹ An illustration of this treatment is seen in the application of the bad faith rule to carriers. The failure of a carrier to settle claims against an insured within policy limits when doing so is prudent, to use its resources to investigate claims, or to oversee their proper handling have each led to determinations that the insurer has failed to place an insured's interests on at least an equal footing with its own.⁵⁰ As a consequence, the carrier may be found liable for bad faith, exposing it to liability beyond the limits of the policy.⁵¹

Because an Insurer's Breach involves the carrier's failure to provide special services where the Favored Insurer Approach Costs exceed Disfavored Insurer Approach Costs, such breach has similarities to bad faith, because the carrier chooses its own economic interests over those of its insured, irresponsibly exposing the insured to risk. In cases of both bad faith and an

⁴⁸ See, e.g., *Vu v. Prudential Prop. & Cas. Ins. Co.*, 33 P.3d 487, 492 (Cal. 2001) ("The insurer-insured relationship, however, is not a true 'fiduciary relationship' in the same sense as the relationship between trustee and beneficiary, or attorney and client.").

⁴⁹ See *State Farm Mut. Auto. Ins. Co. v. Laforet*, 658 So. 2d 55, 58 (Fla. 1995) ("Under liability policies, however, insurance companies took on the obligation of defending the insured, which, in turn, made insureds dependent on the acts of the insurers."); *Vu*, 33 P.3d at 492 (insurer-insured relationship is "often characterized by unequal bargaining power in which the insured must depend on the good faith and performance of the insurer.")

⁵⁰ See *Aecon Bldgs., Inc. v. Zurich N. Am.*, 572 F. Supp. 2d 1227, 1236-37 (W.D. Wash. 2008) (failure to investigate); *Smith v. Gen. Accident Ins. Co.*, 697 N.E.2d 168 (N.Y. 1998) (failure to settle).

⁵¹ See, e.g., *Pavia v. State Farm Mut. Auto. Ins. Co.*, 626 N.E.2d 24, 26-28 (N.Y. 1993). Some courts have treated bad faith as a breach of contract by the carrier, while others have viewed it as an independent tort. See *State Farm Fire & Cas. Co. v. Nicholson*, 777 P.2d 1152, 1154-55 (Alaska 1989). Either way, it is a reflection of the importance of the carrier's Defense Duty or Indemnity Duty, and illustrates how the breach of either of these duties can affect remedies for the breach of the Defense Duty.

Insurer's Breach, the insured is dependent on the carrier, and this circumstance imposes a heightened responsibility to the insured. In turn, this elevated level of obligation influences the consequences of an Insurer's Breach.

Both bad faith and breach of fiduciary duty have been grounds for at least modifying the application of the Compensatory Damages Principle. In the case of bad faith, the Compensatory Damages Principle does not stand in the way of an award of damages beyond the policy limits. This is because bad faith is treated more in the nature of a tort than contract, although tort theory still requires proof that "but for" the carrier's bad faith, the insured would not have suffered a loss beyond policy limits. In the context of breach of fiduciary duty, although damages are ordinarily still dependent upon evidence of proximate cause,⁵² greater flexibility is afforded the plaintiff. For example, the Compensatory Damages Principle may be modified so that the measure of damages is the wrongdoer's profit, not the injury to the plaintiff against whom the breach of fiduciary duty has occurred.⁵³ Furthermore, as will be discussed below, proof of damages may be relaxed.

Efforts to avoid the Compensatory Damages Principle, though unnecessary as discussed above, have led to judicial distinctions between an Insurer's Breach and other kinds of contractual breaches. As noted above, in recognition of the importance of the Defense Duty, its breach has been characterized as depriving the insured of the benefit of its bargain ("Insured Defense Clause Argument"). An Insurer's Breach is treated as so significant as to constitute a repudiation of the insurance policy,⁵⁴ which has been held to preclude the carrier from citing any policy exclusion in defense of its Defense Duty Breach.⁵⁵

Turning to the argument that the Exclusion Bar Rule provides a "windfall" to the insured in the form of insurance coverage to which an insured is not entitled, there is no debate that the Compensatory Damages Principle is intended to avoid

⁵² *E.g.*, Janowiak v. Tiesi, 932 N.E.2d 569, 583 (Ill. App. Ct. 2010); Greenberg v. Joffe, 824 N.Y.S.2d 355, 357 (App. Div. 2006).

⁵³ *See infra* p. 234.

⁵⁴ *Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1135 (Ill. 1999).

⁵⁵ *Id.*

“windfalls.” However, the relevant question is whether its application to an Insurer’s Breach results in an undesired benefit to insurers. Those arguing that the Exclusion Bar Rule confers a windfall on insureds do not consider, first, the detriment to any given insured by virtue of damages from an Insurer’s Breach Pre-Exclusion Resolution, and second, the benefit the carrier realizes through Unwarranted Defense Costs Savings. Furthermore, disgorgement of Unwarranted Defense Costs Savings should be considered in the context of aggregate unwarranted savings to carriers, so that the Exclusion Bar Rule should be viewed as serving a purpose similar to exemplary damages. By enabling the disgorgement of Unwarranted Defense Costs Savings, both exemplary damages and the Exclusion Bar Rule discourage socially undesirable behavior by imposing damages that are not restricted by the Compensatory Damages Principle.⁵⁶

ii. Judicial Constructs That Are Cited in Support of the Exclusion Bar Rule But Are Unpersuasive

Courts seeking a vehicle to justify applying the Exclusion Bar Rule have turned to three related judicial constructs, each based upon the importance of the Defense Duty, in support of arguments that the Exclusion Bar Rule should be applied. The first construct is the doctrine of estoppel. Estoppel is employed where an insurer breaches its duty to defend; the insurer is then estopped from raising policy defenses to coverage.⁵⁷

The problem with this doctrine, as applied to the Exclusion Bar Rule, is that while the insurer has promised a defense to the insured, the breach of this promise does not, in and of itself, give rise to losses beyond the insured’s defense costs. Estoppel is used to prevent a litigant from asserting a defense based on a situation in which such litigant has misled another to the other’s disadvantage.⁵⁸ Estoppel is limited to “filling in gaps” in proof of an existing claim, not the creation of a new remedy.

⁵⁶ Though as noted above, the Exclusion Bar Rule is not incompatible with the Compensatory Damages Principle. See discussion, *supra* pp. 8-10.

⁵⁷ See, e.g., *Emp’rs Ins. of Wausau*, 708 N.E.2d at 1134-35; *Pulte Home Corp. v. Am. S. Ins. Co.*, 647 S.E.2d 614, 617 (N.C. Ct. App. 2007).

⁵⁸ See, e.g., *Ashcraft v. Hunter*, 597 S.W.2d 124, 126 (Ark. Ct. App. 1980) (estoppel from invoking statute of limitations).

A related and overlapping basis for applying the Exclusion Bar Rule is the materiality of the breach, which has been cited as a basis for barring consideration of any exclusions if there is an Insurer's Breach.⁵⁹ In essence, this argument treats the raising of an insurer defense based on a policy exclusion as a dependent covenant requiring compliance with the Defense Duty. However, traditional contract jurisprudence requires that the agreement between the parties articulate this dependency,⁶⁰ or that the breach of the policy in question prevent performance by the non-breaching party.⁶¹ Neither of these factors is present in cases of relying upon materiality in support of the Exclusion Bar Rule.

A third proffered basis for applying the Exclusion Bar Rule is to treat an Insurer's Breach as a violation of its fiduciary duty,⁶² although this characterization can certainly be challenged.⁶³ In the context of a fiduciary relationship, an agent who has been able to seize personally and misappropriate an opportunity belonging to the principal may be liable. Even where there is no proof that the opportunity could have been utilized by the principal, the agent may be liable to the principal for damages.⁶⁴ An example of this would be when the principal was financially unable to, or for other reasons unwilling to undertake, the corporate opportunity that the agent utilizes for the latter's benefit.⁶⁵ What the treatment of damages for breach of fiduciary duty adds in support of the Exclusion Bar Rule is the notion that the remedy for the breach should be flexible and not limited to compensatory damages.

⁵⁹ See *Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co.*, 230 A.2d 21, 26 (Conn. 1967).

⁶⁰ See *Davis v. Woodlake Partners, LLC*, 748 S.E.2d 762, 768 (N.C. Ct. App. 2013).

⁶¹ See *Heyliger v. Tune-Time Fashions, Inc.*, 332 N.Y.S.2d 253, 255 (App. Div. 1972) (“[A] party who prevents his adversary from performing a condition may not rely on such failure to excuse his own non-performance.”).

⁶² See *Hartford Accident & Indem. Co. v. Michigan Mut. Ins. Co.*, 462 N.Y.S.2d 175, 178 (App. Div. 1983) (finding fiduciary relationship between insurer and insured).

⁶³ See *Koger v. Hartford Life Ins. Co.*, 28 S.W.3d 405, 411 (Mo. Ct. App. 2000) (“[N]o fiduciary duty generally exists between insurer and insured.”).

⁶⁴ *Foley v. D'Agostino*, 248 N.Y.S.2d 121, 129 (App. Div. 1964); *Durfee v. Durfee & Canning, Inc.*, 80 N.E.2d 522, 530 (Mass. 1948).

⁶⁵ *Foley*, 248 N.Y.S.2d at 129; *Durfee*, 80 N.E.2d at 530.

Applied to an Insurer's Breach, flexibility on the basis of the special relationship between the insurer and the insured is also invited by the analysis that arises when considering damages for Pre-Exclusion Resolution Insurer's Breach. The argument is that at the time of the breach, an opportunity to defeat the claim through the carrier's expertise was lost by virtue of the Insurer's Breach, which – because of its nature as a fiduciary, which promises to provide extraordinary services – justifies a creative solution. The profits realized by a fiduciary through defalcation of duty are analogous to profits realized by a carrier in the form of Unwarranted Defense Costs Savings. In both cases, there is the loss of an opportunity that is difficult to quantify but which results from the wrongdoing of a party that is entrusted with the protection of the injured party's interests, resulting in a gain by the former and an inchoate loss to the latter. In such situations, disgorgement has been imposed upon the wrongdoer as a remedy for breaching its duty. This approach discourages a Disfavored Insurers Approach while resolving doubts as to actual damages in favor of the principal.

There is no question that damages for Insurer's Pre-Exclusion Resolution Breach are not easily proven. However, victims are often given great latitude in damage calculations, particularly where the wrongdoer has a fiduciary duty to the victim, or at least has the ability to avoid the injury in the first instance, and the wrongdoer nevertheless consciously engages in conduct that may lead to the subject damage. The wrongdoing in question may involve the dishonor of contract provisions, such as the Defense Clause, or judicially crafted theories of liability, such as misappropriation of business opportunity. In the case of the Exclusion Bar Rule, application is also supported by considerations of the efficient administration of the courts through adherence to judicial constructs. Before turning to this topic, it is worth noting that contract principles are not the exclusive ground upon which the Exclusion Bar Rule can be applied.

iii. Judicial Conventions and Procedural Rules

Putting aside the jurisprudence concerning damages for breach of contract or fiduciary duty, the question arises:

should the courts fashion a judicial construct which provides that a carrier refusing to follow a Favored Insurers Approach loses the ability to raise any exclusion that the carrier might otherwise be able to assert in a suit against the carrier for indemnity? This question raises the threshold issue of the extent to which courts are permitted to craft procedural rules that determine substantive rights. The answer depends upon the relationship between such substantive rights and judicial control of the administration of cases through judicial constructs and procedural rules.⁶⁶

In furtherance of their ability to administer cases before them, judges have considerable latitude in establishing the procedures that should be followed by litigants, and the consequences that result from the failure to follow these procedures.⁶⁷ Those consequences can be outcome determinative of litigants' claims and defenses.⁶⁸ For example, where litigants have failed to follow court-approved steps in the pursuit of court cases, or to pursue diligently their rights or obligations in the course of litigation, sanctions may be imposed, including preclusion and dismissal of the offending party's claim or defense, often without regard for the merits.⁶⁹ These measures are taken to promote the integrity of procedures in cases that are proceeding through the judicial system, *e.g.*, the preservation of evidence when there is the possibility that it is relevant to potential or pending litigation. In cases where procedural violations lead to loss of substantive rights, the judicial need to maintain the orderly progress of pending cases takes precedence over the underlying merit of the case or defense. Though dismissal of cases or defenses based on violation of procedural rules or judicial constructs has been called drastic, and has of-

⁶⁶ "Procedural rule," defined broadly, is a rule that does not directly relate to the merits of the case.

⁶⁷ *See, e.g., In re G.G.*, 92 A.3d 648, 651 (N.H. 2014) ("[T]he trial court has inherent power to control every aspect of the proceeding before it. For this reason, a trial judge has the authority to determine the manner and procedure by which a case will be tried, except where limited by statute, court rule, or constitutional fiat.")

⁶⁸ *See, e.g., Youni Gems Corp. v. Bassco Creations Inc.*, 896 N.Y.S.2d 315, 317 (App. Div. 2010) (affirming striking of defendants' answer and counterclaim for willful failure to comply with court's discovery order), *dismissing appeal*, 936 N.E.2d 460 (N.Y. 2010).

⁶⁹ *See id.*

ten been the last resort following warnings and sometimes fines, when this sanction is needed to maintain the credibility of the court's directives and rules, it is not forestalled by the need to prove with precision, or sometimes at all, the underlying harm caused by the breach of the rule.

Even where the smooth administration of justice is not a factor in imposing an outcome determinative consequence, courts may dispose of a claim with prejudice on considerations other than merit, such as the dismissal for lack of due diligence in commencing a suit for equitable relief. To illustrate, where there has been an unjustifiable delay in bringing a claim for injunctive relief,⁷⁰ the judicially created doctrine of laches may be employed to dismiss the case.⁷¹ Laches involves a court's dismissal of an action on the basis of lack of diligence in bringing suit.⁷² As with the Favored Insurers Approach, there may be no legislation that requires the expeditious commencement of an action for equitable relief, but there are serious judicial consequences for not doing so promptly.⁷³

Similarly, the spoliation rule, another judicial creation, requires that a party that knows, or has reason to believe, that litigation will be commenced involving preservable tangible evidence, to maintain such evidence.⁷⁴ The imposition of the spoliation rule can lead to preclusion based upon a presumption that the spoliated evidence would have supported the claims of the non-spoliating party. The rule does not require proof that,

⁷⁰ The remedy for the delay in bringing an action at law is typically codified in legislation, and so not within the direct province of the court, although courts interpret Statute of Limitations statutes and routinely hold out exceptions to them and provide them with the gloss of judicial interpretation.

⁷¹ See, e.g., *Carriage House Realty Co. v. Mun. Corp. of Yonkers*, 363 N.Y.S.2d 456, 462-63 (Sup. Ct. 1975).

⁷² The imposition of the sanction does not necessarily require the court to address the merits of the equitable claim prior to dismissal. See *id.* However, a number of courts have looked at this as a factor in determining to dismiss based on laches. See *Day v. Estate of Wiswall*, 381 P.2d 217, 220 (Ariz. 1963) ("Unlike the statute of limitations, the doctrine of laches is properly applied only after a consideration of the circumstances and merits of a suit").

⁷³ See, e.g., *Fulton v. Fulton*, 106 A.3d 127, 131-36 (Pa. Super. Ct. 2014) (dismissing equitable causes of action on laches grounds).

⁷⁴ See, e.g., *Strong v. City of New York*, 973 N.Y.S.2d 152, 156-57 (App. Div. 2013) (erasure of audiotapes).

on the merits, the issue arising from the spoliated evidence would have been conclusively resolved in favor of the non-spoliating party; rather, the merits may be conclusively resolved upon the application of the spoliation rule itself in favor of the non-spoliating party.⁷⁵ The spoliation rule is one of practicality, balancing the relative burdens and consequences of applying the rules.⁷⁶ With the evidence destroyed, there may be no ability to determine how the spoliated evidence would affect the outcome of the litigation, only that it might have such effect.

As with the Exclusion Bar Rule's application to the issue of the possibility that an insured would prevail in the Underlying Action, doubt is resolved against the offending party in many spoliation cases because it is within the party's control to prevent spoliation.⁷⁷ The difficulty in proving proximate cause is resolved against the wrongdoer as a means of discouraging undesirable conduct through conclusively shifting burdens of proof where the proof may be difficult or impossible.⁷⁸

Prejudice is an issue that often arises both in the application of both the spoliation rule and the Exclusion Bar Rule.

⁷⁵ However, proof may be required that the spoliated evidence is relevant to the issue that is subject to disposal, and that the spoliated evidence might potentially affect the outcome of the issues to be resolved against the offending party. See *Gallagher v. Magner*, 619 F.3d 823, 844 (8th Cir. 2010) (prejudice is required element for imposition of spoliation sanctions).

⁷⁶ See *Victor Stanley, Inc. v. Creative Pipe, Inc.*, 269 F.R.D. 497, 522 (D. Md. 2010) (“[T]he scope of preservation should somehow be proportional to the amount in controversy and the costs and burdens of preservation.”) (quoting Paul W. Grimm et al., *Proportionality in the Post-Hoc Analysis of Pre-Litigation Preservation Decisions*, 37 U. BALT. L. REV. 381, 405 (2008)); see also *Cedars-Sinai Med. Ctr. v. Superior Court*, 954 P.2d 511, 519-21 (Cal. 1998) (declining to recognize independent tort for spoliation of evidence where, *inter alia*, “The risk of erroneous spoliation liability could also impose indirect costs by causing persons or entities to take extraordinary measures to preserve for an indefinite period documents and things of no apparent value solely to avoid the possibility of spoliation liability if years later those items turn out to have some potential relevance to future litigation.”).

⁷⁷ See, e.g., *Peschel v. City of Missoula*, 664 F. Supp. 2d 1137, 1143-48 (D. Mont. 2009) (ordering, in response to spoliation of video recording taken by police, a finding that it is established that officers used unreasonable force to effect arrest).

⁷⁸ See *id.* at 1147 (noting that the spoliated video recording “constituted the best evidence of what occurred during the course of the arrest.”).

The former rule generally requires prejudice in the form of at least the loss of the opportunity to prove that the spoliated evidence would support the non-spoliating party's position. While the Exclusion Bar Rule prevents the carrier from proving that an exclusion would have avoided coverage, which carriers argue is prejudicial to their rights under the policy, the flaw in this carrier argument is carriers' failure to factor in the prejudice to the insured of the Insurer's Breach Pre-Exclusion Resolution. As discussed above, this issue turns upon the possibility that a carrier could have, but failed, to provide a defense that might have resulted in a determination in the Underlying Action favorable to the insured.

The spoliation rule has been applied by courts to the destruction of evidence occurring both before and after the commencement of suit, although spoliation is certainly treated with far less tolerance if it occurs after commencement of a lawsuit. Before the commencement of litigation, imprudent behavior in the destruction of the relevant evidence leads to the application of the spoliation rule because the party destroying the evidence should reasonably anticipate the commencement of litigation in which such evidence would be relevant.⁷⁹

Similarly, the Exclusion Bar Rule is implicated by acts and omissions that occur before the commencement of the Underlying Action, or during its prosecution, when the carrier refuses to provide, or to continue to provide, for the defense of an insured, thereby breaching its Defense Duty. The breach of the Defense Duty is typically the product of a calculated decision not to defend in the Underlying Action for economic reasons, and exposes the abandoned insured to liability in the Underlying Action. Thereafter, the Exclusion Bar Rule is applied to an indemnity action against the insurer, thereby discouraging carriers from taking a Disfavored Insurers Approach and relieving the insured of the burden of proving the damages resulting from the Insurer's Breach.⁸⁰

⁷⁹ See *Rambus, Inc. v. Infineon Techs. AG*, 222 F.R.D. 280, 288 (E.D. Va. 2004) (“[O]nce a party reasonably anticipates litigation, it has a duty to suspend, as to documents that may be relevant to the anticipated litigation, any routine document purging system that might be in effect; failure to do so constitutes spoliation.”).

⁸⁰ See *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 179 (Cal. 1966) (holding insurer who wrongfully refused to defend to be responsible for entire judgment where

III. The Role of Fairness

The issue of the fairness of the Exclusion Bar Rule can be dealt with in a framework that takes into account: (1) the burden to the insurer of pursuing a Favored Insurers Approach; (2) the rights and the reasonable expectations of the insured; (3) the equities that are involved in determining whether an insurer or insured should bear the consequences of the uncertainty of damages caused by a Pre-Exclusion Resolution Breach (“Balancing of Interests Analysis”); and (4) public policy.

A. *The Carriers’ Burden of Proving a Favored Insurers Approach*

Carriers argue that the Exclusion Bar Rule is unfair because it results in “automatic indemnity.”⁸¹ However, this argument is badly flawed. Indemnity is not “automatic,” because the carrier can bring a declaratory judgment action or defend under a reservation of rights.⁸² Rather, the application of the Exclusion Bar Rule follows a conscious decision by the carrier to pursue a Disfavored Insurer Approach. However, the subject does raise the question of what burden a carrier must assume in order to avoid the consequences of the Exclusion Bar Rule. In a number of jurisdictions that follow the Exclusion Bar Rule, the carrier has the option of pursuing a Favored Insurers Approach.⁸³

insured otherwise would face an “impossible burden” in proving the extent of the loss caused by the insurer’s breach).

⁸¹ See Brief for Complex Ins. Claims Litig. Ass’n & Am. Ins. Ass’n, as Amici Curiae Supporting Defendant-Appellant-Respondent, *K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co.*, 6 N.E.3d 1117 (N.Y. 2014), 2013 WL 6924836 at 19-22, 24, & 26-27.

⁸² See, e.g., *Emp’rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134-35 (Ill. 1999).

⁸³ See, e.g., *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 67 A.3d 961, 993 (Conn. 2013) (insurer could have defended under a reservation of rights); *Emp’rs Ins. of Wausau*, 708 N.E.2d 1122 (insurer could have brought a declaratory judgment action or defended under a reservation of rights); *Radke v. Fireman’s Fund Ins. Co.*, 577 N.W.2d 366, 369 (Wis. Ct. App. 1998) (insurer may enter into a non-waiver agreement with insured in which insurer agrees to defend and insured acknowledges the insurer’s right to contest coverage, insurer may request bifurcated trial or a declaratory judgment so that

As applied to carriers, the burden of following a Favored Insurers Approach includes the expense of defending the insured Pre-Exclusion Resolution and that of initiating litigation in the form of declaratory judgment action. Where the exclusion is valid, carriers argue that such costs are not their responsibility because there is no coverage. However, prior to the resolution of the purported exclusion, the carrier is under a duty to incur these costs in any event, which may in fact be substantial, but are no greater than the law requires.⁸⁴ Because the carrier has received payments in the form of litigation insurance, carriers are not prejudiced by resolving the issue of any exclusions while providing a defense.⁸⁵ This is the burden that the carrier has assumed when drafting broad Defense Clauses in order to control litigation against the insured.

B. *The Insured's Interests in Pre-Exclusion Resolution*

Turning to the insured's interests, there is the expectation that the carrier will satisfy its Defense Duty until there is an Exclusion Resolution.⁸⁶ As discussed above, the insured's expectation arises not only from the breadth of the Defense Clause, but from the insurer's presumed knowledge of the law that requires the carrier to defend until the issue of coverage is resolved, and also upon the insured's payment of premiums.⁸⁷

the coverage issue may be resolved before the liability and damage issues, or insurer may file a reservation of rights which permits the insured to pursue his own defense not subject to the insurer's control, but insurer agrees to pay for the legal fees incurred).

⁸⁴ See *El-Com Hardware, Inc. v. Fireman's Fund Ins. Co.*, 111 Cal. Rptr. 2d 670, 679 (Ct. App. 2001) (duty to defend continues until insurer establishes there is no potential for coverage).

⁸⁵ See *Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford*, 477 N.E.2d 441, 444 (N.Y. 1985) ("The insured's right to representation and the insurer's correlative duty to defend suits, however groundless, false or fraudulent, are in a sense 'litigation insurance' expressly provided by the insurance contract.").

⁸⁶ See *El-Com Hardware, Inc.*, 111 Cal. Rptr. 2d at 679 (duty to defend continues until insurer establishes there is no potential for coverage).

⁸⁷ See *Montrose Chem. Corp. v. Superior Court*, 861 P.2d 1153, 1157 (Cal. 1993) ("The insured's desire to secure the right to call on the insurer's superior resources for the defense of third party claims is, in all likelihood, typically as significant a motive for the purchase of insurance as is the wish to obtain indemnity for possible liability.").

The carrier itself is well aware of the insured's expectations, of the carrier's own role in rendering the insured vulnerable, and of the carrier's own superior ability to defend claims compared to that of the insured.⁸⁸ Depriving the insured of the benefit of having litigation insurance at the time when the insured needs that purchased protection causes hardship to the insured.⁸⁹ These circumstances and the carrier's knowledge of the insured's position weigh heavily in favor of the insured in the Balancing of Interests Analysis. One's knowledge of another's reliance on him may give rise to a heightened duty to that party. As the court held in *Cahaly v. Benistar Property Exchange Trust Co.*,⁹⁰ "[w]here a plaintiff reposes trust and confidence in the defendant, and the defendant knows of the plaintiff's reliance on him, a fiduciary duty may be created."⁹¹

C. *The Equities Involved in Imposing the Exclusion Bar Rule*

1. The Role of the Degree of the Carrier's Culpability

A number of factors, including Insurer's Approach Variables, are germane to determining the degree of the culpability associated with an Insurer's Breach. Where the Defense Duty is clear from the pleading, issues raised by the exclusion are patently inapplicable, so the insurer does not even have a colorable excuse for failing to defend,⁹² and the Insurer's Breach

⁸⁸ *MBIA Inc. v. Fed. Ins. Co.*, 652 F.3d 152, 167 (2d Cir. 2011) (acknowledging that insureds "may lack the expertise and experience of an insurer ...").

⁸⁹ *See Haskell, Inc. v. Superior Court*, 39 Cal. Rptr. 2d 520, 529 n.14 (Ct. App. 1995) ("An insured obtains liability insurance in substantial part in order to be protected against the trauma and financial hardship of litigation. If the courts did not impose an immediate defense obligation upon a showing of a 'potential for coverage,' thereby relieving the insured from the burden of financing his own defense and then having to sue the insurer for reimbursement, the premiums paid by the insured would purchase nothing more than a lawsuit.").

⁹⁰ *See Cahaly v. Benistar Prop. Exch. Trust Co.*, 864 N.E.2d 548 (Mass. App. Ct. 2007).

⁹¹ *Id.* at 560.

⁹² For example, in *K Investment Group, LLC v. American Guarantee Liability & Insurance Co.*, 936 N.Y.S.2d 139 (App. Div. 2012), an intermediate appellate court observed that the pleading in the Underlying Action rendered the exclusions upon which the carrier relied "patently inapplicable." *Id.* at 141. This was the case because the policy's definition of "claim" was from the per-

evinces a high degree of culpability. In contrast, instances where the Insurer's Breach concerns a claim that falls entirely within the exclusion, or where the applicable exclusion involves some level of fault by the insured, the Insurer's Breach is more defensible.

2. The Placement of the Burden

Finally, there is the issue of who should bear the burden created by the uncertainty of damages caused by the carrier's Pre-Exclusion Resolution breach.⁹³ The Compensatory Damages Principle would impose such damages upon the insured because the burden of showing that the breach caused damage is part of the insured's *prima facie* case against the carrier. However, the cases are legion which hold that a party that breaches

spective of the claimants in the Underlying Action, and in the cited case, the pleadings in the Underlying Action asserted causes of action that did not rely on facts that would have made the claims subject to the exclusions, *i.e.*, in the Underlying Action, it was alleged that the insured was the claimants' attorney and provided services to the claimants. The exclusions were, therefore, inapplicable, and the carrier could have challenged the allegations in the complaint in the Underlying Action. The applicability of the exclusions was also traversable, *i.e.*, it could have been contested whether the insured was not the claimants' attorney. The Court of Appeals, in *K2 Investment Group, LLC*, disagreed with the intermediate appellate court, finding an issue of fact as to the applicability of the subject exclusions. *K2 Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, 6 N.E.3d 1117, 1120-21 (N.Y. 2014). In *K2 Investment Group, LLC*, the Court indicated that if the malpractice resulted from a conflict between the insured's role as attorney for the claimants and his role as a principal of the company which borrowed money from the claimants that ultimately was not repaid, then the exclusions applied. *See id.* at 1121.

⁹³ The desire to avoid uncertainty is also a factor in those jurisdictions where either the Exclusion Survival Rule or the Exclusion Bar Rule represents longstanding precedent. However, if compelling reasons exist, courts will depart from *stare decisis*. *See Am. Indian Agric. Credit Consortium, Inc. v. Standing Rock Sioux Tribe*, 780 F.2d 1374, 1378 (8th Cir. 1985) ("[T]he values of stability and judicial economy promoted by *stare decisis* must yield when reason and fairness so compels."); *People v. Bing*, 558 N.E.2d 1011, 1014 (N.Y. 1990) ("Although a court should be slow to overrule its precedents, there is little reason to avoid doing so when persuaded by the 'lessons of experience and the force of better reasoning.'") (quoting *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 407-08 (1932) (Brandeis, J., dissenting)); *State ex rel. State Dep't of Transp., Div. of Highways v. Reed*, 724 S.E.2d 320, 324 (W. Va. 2012).

a duty will bear the consequences of any resulting uncertainty in the calculation of damages.⁹⁴

Assessing whether the Exclusion Bar Rule imposes disproportionate consequences for the breach of an insurer's Defense Duty requires consideration of the nature of the relationship between the insured and the insurer. As has been touched upon above, as to at least some aspects of this relationship, the insurer has been treated as having a fiduciary duty to the insured.⁹⁵ Although no decisions appear to directly base the employment of the Exclusion Bar Rule upon this confidential status, some courts have cited the existence of a fiduciary relationship to avoid the Compensatory Damages Principle. For example, as previously discussed, where a fiduciary misappropriates a corporate opportunity, courts have held that the damages to the company are not what the company lost, but what the fiduciary gained.⁹⁶ As has also been argued,⁹⁷ applying this reasoning to insurers that have breached their Defense Duty, the Exclusion Bar Rule can be used to justify disgorgement of costs saved by insurers as a result of breaches of their duty to defend.

3. Public Policy

Two public policy considerations are relevant to the application of the Exclusion Bar Rule. First, there is the benefit derived from courts' protection of the sanctity of contracts, in furtherance of which courts have acted to discourage antisocial conduct, such as with bad faith, that is motivated by economic

⁹⁴ See, e.g., *Contemporary Mission, Inc. v. Famous Music Corp.*, 557 F.2d 918, 926 (2d Cir. 1977) (applying New York law); *Steelduct Co. v. Henger-Seltzer Co.*, 160 P.2d 804, 813 (Cal. 1945); *Eden United, Inc. v. Short*, 653 N.E.2d 126, 131 (Ind. Ct. App. 1995).

⁹⁵ *Doe ex rel. Doe v. Allstate Ins. Co.*, 653 So. 2d 371, 374 (Fla. 1995).

⁹⁶ See *Epstein Eng'g P.C. v. Cataldo*, 955 N.Y.S.2d 508, 508 (App. Div. 2012) ("A faithless servant must account not only for profits attributable to clients poached from the principal, but for all profits ascribable to the wrongful diversion of business.").

⁹⁷ See *Nat'l Sur. Corp. v. Immunex Corp.*, 297 P.3d 688, 694 (Wash. 2013) ("[W]hen an insurer declines to defend altogether, it saves money on legal fees but assumes the risk it may have breached its duty to defend or committed bad faith.").

factors that have led to breaches of contract.⁹⁸ In promoting the integrity of contracts, courts have created judicial constructs, such as the Exclusion Bar Rule, to serve as disincentives from the pursuit of conduct that is contrary to social policy, *e.g.*, a Disfavored Insurers Approach.⁹⁹ The disincentive created by the Exclusion Bar Rule is the economic consequences associated with the carrier's loss of the ability to raise exclusions when a carrier has pursued a Disfavored Insurers Approach.

The second policy consideration is judicial economy. In *K2 I* it was observed that allowing the raising of exclusions after the breach of the Defense Clause would result in a multiplicity of lawsuits.¹⁰⁰ Carriers, on the other hand, have argued that the Exclusion Bar Rule actually promotes litigation because the carriers would be forced to bring declaratory judgment actions in every case.¹⁰¹ However, since declaratory judgment actions are a Favored Insurers Approach, litigation leading to the resolution of exclusions before the abandonment of the insured is encouraged. Furthermore, it is entirely possible that, in a number of cases, the issue of exclusions can be addressed in the Underlying Action – for example, whether the exclusion applies and whether and to what extent injury is caused, under which circumstances judicial economy would be furthered by requiring the carrier to raise the issue earlier.¹⁰²

⁹⁸ See, *e.g.*, *Pavia v. State Farm Mut. Auto. Ins. Co.*, 626 N.E.2d 24, 26-28 (N.Y. 1993) (setting standard for bad faith breach of insurance contract).

⁹⁹ See, *e.g.*, *Emp'rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1134-35 (Ill. 1999).

¹⁰⁰ See *K2 Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, 993 N.E.2d 1249, 1254 (N.Y. 2013) (stating that permitting insurers to raise exclusions after wrongfully refusing to defend “would promote unnecessary and wasteful litigation ...”).

¹⁰¹ See Brief for N.Y. Ins. Ass'n, Inc. et al. as Amici Curiae Supporting Defendant-Appellant-Respondent at 27-28, *K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co.*, 6 N.E.3d 1117 (N.Y. 2014).

¹⁰² In *K2*, this was the case. There the question of whether the insured was attorney for K2 Investment Group, LLC and ATAS Management Group, LLC, and whether a third party's claims against the insured were based upon the insured's providing services to a company the insured controlled or were based upon his status within that company, could have been raised in the underlying suit.

IV.

The *K2* decisions touch upon many of the issues that relate to the consequences of the carrier's breach of its Defense Duty. The underlying facts of the case are somewhat involved. The insured was covered by a legal malpractice liability policy that contained exclusions for "claims" that were "based upon or arising out of, in whole or in part . . . the alleged acts or omissions by any Insured, . . . for any business enterprise . . . in which any Insured has a Controlling Interest,"¹⁰³ where "Controlling Interest" is defined as ten percent (10%) or greater ownership in an entity,¹⁰⁴ or were "based upon or arising out of, in whole or in part . . . the insured's capacity or status as an officer, director, partner . . . , shareholder, manager . . . of a business enterprise, charitable organization or pension, welfare, profit sharing, mutual or investment fund or trust."¹⁰⁵ The insured, who was a member and principal of a company called Goldan, LLC ("Goldan") which borrowed money from the third-party claimants, K2 Investment Group, LLC and ATAS Management Group, LLC (collectively, "K2/ATAS"), failed to record mortgages to secure the loans or obtain title insurance for K2/ATAS. The insured also signed promissory notes obligating Goldan to pay K2/ATAS, and personally guaranteed such notes and signed the mortgages on behalf of Goldan. Goldan defaulted on the promissory notes and was placed into bankruptcy. After the default, K2/ATAS commenced suit against the insured, Goldan, and the other principal of Goldan.

Claims asserted against the insured for legal malpractice were based exclusively upon the insured's failure to record the mortgages and to obtain title insurance for K2/ATAS. Initially, the insurer retained counsel to defend the insured, but then disclaimed and withdrew from its defense of the insured before issue was joined. Eventually, the insured defaulted in the underlying case and assigned his claims against the insurer to K2/ATAS, which then commenced an indemnity action against the insurer. In the indemnity action, both the insurer and

¹⁰³ Joint Record on Appeal at 205 ¶ III(E), *K2 Inv. Grp., LLC v. Am. Guarantee & Liab. Ins. Co.*, 993 N.E.2d 1249 (N.Y. 2013).

¹⁰⁴ *Id.* at 209 ¶ VI(D)(1).

¹⁰⁵ *Id.* at 205 ¶ III(D).

K2/ATAS moved for summary judgment. The plenary court denied K2/ATAS's motion for summary judgment on bad faith and dismissed such claims, but granted K2/ATAS's motion for summary judgment on their indemnity claims up to the policy limits, commenting, "[t]he insurance company had a clear obligation to defend in this case. . . . It decided to risk not defending it. It made a very bad judgment in my judgment."¹⁰⁶

Upon appeal to the Appellate Division, First Department, a three-to-two majority, focusing upon the definition of the term "claim," affirmed and held that the judgment against the insured was exclusively based on claims under the policy, and that the exclusions relied upon were patently inapplicable.¹⁰⁷ Two dissenting justices reasoned that there was an issue of fact as to whether the exclusions applied.¹⁰⁸ The insurer appealed, as of right, to the New York State Court of Appeals.

In *K2 I*, the Court of Appeals held that, based upon the abandonment of the insured by the insurer, the Exclusion Bar Rule should be applied, which application deprived the insurer of the right to raise exclusions. Relying on a prior decision in *Lang v. Hanover Insurance Co.*¹⁰⁹ and expanding the traditional interpretation of this decision, the Court held where a disclaimer has been made in breach of the Defense Duty, the carrier is barred from raising exclusions in an indemnity action.¹¹⁰ This treatment of the disclaimer provided the carrier with the incentive to follow a Favored Insurer Approach, *viz.*, to resolve issues relating to the exclusion while defending the insured. It also provided the insured with the benefit of the bargain, but never reached the ground upon which the First Department holding was based.

However, the Court granted reargument and, stating that there was much to be said for either side of the issue, decided

¹⁰⁶ Transcript of Oral Argument at 30-31, *K2 Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, Index No. 117902/2009 (Sup. Ct. N.Y. County June 9, 2010) (per JHO Ira Gammerman).

¹⁰⁷ *K Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, 936 N.Y.S.2d 139, 141-42 (App. Div. 2012), *aff'd*, 993 N.E.2d 1249 (N.Y. 2013), and *rev'd in part on reargument*, 6 N.E.3d 1117 (N.Y. 2014).

¹⁰⁸ *Id.* at 145-46 (Andrias, J., dissenting).

¹⁰⁹ *Lang v. Hanover Ins. Co.*, 820 N.E.2d 855 (N.Y. 2004).

¹¹⁰ *K2 Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, 993 N.E.2d 1249, 1253-54 (N.Y. 2013).

that *stare decisis* should be followed and the Exclusion Survival Rule applied.¹¹¹ This time the Court of Appeals did reach the issues upon which the majority of the Appellate Division found in the case in favor of K2/ATAS, but agreed with the minority that there was an issue of fact precluding summary judgment.¹¹²

K2 I and *K2 II* illustrate the struggle that courts face in resolving the issue of whether to apply the Exclusion Bar Rule or the Exclusion Survival Rule. However, *K2 I* does not tackle the issues in depth, and *K2 II* is particularly superficial in its treatment of the issues.

V. Proposal

The author recommends the adoption of the Exclusion Bar Rule, with certain qualifications. The rule is justified by the balancing of burdens of insured and insurer, which weighs heavily in favor of the insured, as does public policy in favor of the integrity of contracts. Overall fairness, which considers the importance of the Defense Clause and the integral part it plays in the benefit of the bargain of the insurance contract, supports the application of the Exclusion Bar Rule.

However, there are circumstances when a carrier is justified in not defending an insured without first bringing a declaratory judgment action. One such circumstance is when the claim, as presented to the carrier, falls entirely inside the exclusion.¹¹³ Another such circumstance is when it is clear there is collusion between the insured and the third party claimant.

VI. Issues to Investigate

¹¹¹ See *K2 Inv. Grp., LLC v. Am. Guarantee Liab. & Ins. Co.*, 6 N.E.3d 1117, 1120 (N.Y. 2014). In this case, the case forming the basis for the *stare decisis* was *Servidone Constr. Corp. v. Sec. Ins. Co. of Hartford*, 477 N.E.2d 441 (N.Y. 1985), which had held that when an insurer breached its duty to defend and the insured concluded a reasonable settlement with the injured party, the insurer was not precluded from raising coverage defenses in arguing it was not liable for the settlement amount. See *id.* at 444.

¹¹² *K2 Inv. Grp., LLC*, 6 N.E.3d at 1120-21.

¹¹³ However, this situation would not even trigger a duty to defend; hence, it need not be treated as an exception to the Exclusion Bar Rule.

Some subjects that are worthy of further investigation are how often disclaimers by carriers of the Defense Duty result in actions against the carriers; what portion, on average, of a liability insurance premium is devoted to defense costs, and how this portion is calculated; what portion is attributable to Pre-Exclusion Resolution Defense Costs; whether the requirement, in jurisdictions employing the Exclusion Bar Rule, that insurers bring declaratory judgment actions prior to refusing to defend insureds, has the effect of increasing or decreasing the total number of actions brought; the economic effect on carriers of the application of the Exclusion Bar Rule where such rule applies; and the disparity between success rates for insured defendants in actions in which their carriers defend them, and those in actions in which their carriers do not defend them. Finally, it would be useful to know, in instances in which an Insurer Breach has occurred, what percentage of the insureds have brought an action against the insurers.

The relevance of these subjects should be apparent from the preceding discussions. Whether the answer should affect the author's proposal is doubtful because, as a general proposition, an award of Pre-Exclusion Resolution Insurer Breach Damages is consistent with applicable law, such as the Compensatory Damages Principle, as discussed above. However, supporting arguments, such as those based on Unwarranted Defense Costs Savings, would be affected by such investigation.

VII. Conclusion

The author advocates a rule that would preclude an insurer that is confronted with a claim implicating Basic Coverage from defending a suit for breaching its Defense Duty prior to the resolution of the merits of any exclusion. This rule does not offend the Compensatory Damages Principle because the insured has paid premiums for defense in reliance upon the carrier's satisfying this duty. In light of the special relationship between the carrier and the insured, the difficulty of determining damages, and public policy that favors a prompt determination of coverage issues, when the insurer fails to defend before a resolution of the merits of the exclusion, it is appropriate to

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presume the insured's damages are equal to any judgment against it in the underlying action.