

## The Tort Liability Regime and the Duty to Defend

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## INTRODUCTION

The liability reform debates of the last twenty years have prompted academics, policymakers, and legislatures to devote increased attention to the theory and workings of the massive liability insurance structure in America. These efforts have taught us much about important topics, including the demand for liability insurance;<sup>1</sup> the relationship of liability insurance to the goals of corrective justice and efficiency;<sup>2</sup> the relative merits of first-party versus third-party insurance in achieving efficient levels of deterrence and loss-spreading;<sup>3</sup>

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1. See Randall R. Bovbjerg, *Liability and Liability Insurance: Chicken and Egg, Destructive Spiral, or Risk and Reaction?*, 72 TEX. L. REV. 1655, 1679 (1994) (urging "closer examination of the costs and benefits of the underlying tort rules and processes whose results are insured"); Steven W. Pottier & Robert C. Witt, *On the Demand for Liability Insurance: An Insurance Economics Perspective*, 72 TEX. L. REV. 1681, 1681 (1994) (arguing that liability insurance supply and demand is driven by the legal liability imposed for accidental loss and injury to third parties); Kent D. Syverud, *On the Demand for Liability Insurance*, 72 TEX. L. REV. 1629, 1632 (1994) (arguing that "insurers and attorneys . . . have successfully . . . driven us to overconsume liability insurance"). For the impact of tort reform on liability insurance costs, see generally Glenn Blackmon & Richard Zeckhauser, *State Tort Reform Legislation: Assessing Our Control of Risks*, in TORT LAW AND THE PUBLIC INTEREST 272, 273 (Peter H. Schuck ed., 1991) (appraising the success of tort reform in reducing insurer losses and insurance premiums); W. Kip Viscusi & Patricia Born, *Medical Malpractice Insurance in the Wake of Liability Reform*, 24 J. LEGAL STUD. 463, 463 (1995) (examining the effect of liability reforms on medical insurance from 1984-91).

2. See STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 186-261 (1987) (discussing the relationship of liability insurance to the efficiency aims of tort law); Gary T. Schwartz, *The Ethics and the Economics of Tort Liability Insurance*, 75 CORNELL L. REV. 313, 365 (1990) (examining the relationship of liability insurance to the goals of tort law).

3. See Patricia M. Danzon, *Tort Reform and the Role of Government in Private Insurance Markets*, 13 J. LEGAL STUD. 517, 518-19 (1984) (discussing both an "efficient liability rule" that achieves, among other things, "risk bearing," and the "reduced incentives for injury prevention" posed by a "rule of third-party liability"); Jon D. Hanson & Kyle D. Logue, *The First-Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 136-37 (1990) (arguing that first-party insurance leads to externalizing accident costs to the insurers, thereby affecting the efficiency of products liability law); George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1590 (1987) (arguing that tort law reform requires a "redefinition of liability standards to better achieve accident reduction and insurance"); Ellen Smith Pryor, *The Tort Law Debate, Efficiency, and the Kingdom of the Ill: A Critique of the Insurance Theory of Compensation*, 79 VA. L. REV. 91, 94-95 (1993) (arguing that the insurance theory of compensation—that individuals' insurance choices should determine appropriate compensation payments—is a flawed answer to the question of how tort law should compensate for nonpecuniary harms).

the role of the insurer's duty to settle in modern tort litigation;<sup>4</sup> the limits of the insurance mechanism with respect to environmental injury;<sup>5</sup> the workings of the liability insurance regime in the medical malpractice context;<sup>6</sup> and how the law of "bad faith" affects claims processing and tort claim management.<sup>7</sup>

Of the items left on the research agenda, one of the most important is the "defense insurance" that most Americans have in some form or another.<sup>8</sup> Virtually all standard personal and commercial lia-

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4. See Seth J. Chandler, *Reconsidering the Duty to Settle*, 42 *DRAKE L. REV.* 741, 744 (1993) (analyzing the economic effects of the insurer's duty to settle); Charles Silver, *A Missed Misalignment of Interests: A Comment On Syverud, The Duty to Settle*, 77 *VA. L. REV.* 1585, 1596 (1991) (commenting on Professor Syverud's views regarding insurers' incentives to reject settlement offers); Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique*, 72 *TEX. L. REV.* 1345, 1348 (1994) (questioning the rationale for extracontractual liability for failure to settle); Kent D. Syverud, *The Duty to Settle*, 76 *VA. L. REV.* 1113, 1208 (1990) (examining the duty to settle and the relationship of tort litigation to liability insurance).

5. See Kenneth S. Abraham, *Environmental Liability and the Limits of Insurance*, 88 *COLUM. L. REV.* 942, 944 (1988) (tracing the demise of the environmental liability insurance market to the uncertainty caused by new environmental liability).

6. The literature relating to liability insurance in the medical malpractice arena is extensive. See PATRICIA M. DANZON, *MEDICAL MALPRACTICE: THEORY, EVIDENCE, AND PUBLIC POLICY* 226 (1985) (proposing tort law reforms to make the malpractice system "more cost-effective for purposes of both deterrence and compensation"); FRANK A. SLOAN ET AL., *INSURING MEDICAL MALPRACTICE* 15 (1991) (describing the workings of medical malpractice insurance to provide an empirical basis for policy proposals); NEIL VIDMAR, *MEDICAL MALPRACTICE AND THE AMERICAN JURY* 265 (1997) (dispelling the view that malpractice juries are incompetent and prejudiced on the basis of empirical evidence); PAUL C. WEILER, *MEDICAL MALPRACTICE ON TRIAL* 160 (1991) (arguing that addressing the critical financial needs of the patient furthers the compensation and prevention goals of malpractice law); Viscusi & Born, *supra* note 1, at 463 (using data from firms writing medical malpractice insurance from 1984 to 1991 to gauge the effect of liability reforms on profitability).

7. See generally Ellen Smith Pryor & Charles Silver, *Introduction to Symposium on the Law of Bad Faith in Contract and Insurance*, 72 *TEX. L. REV.* 1203, 1203-05 (1994) (discussing the status of bad faith law and introducing collected scholarship on contract and insurance issues).

8. In recent years, the scholarly literature has begun to address defense insurance in more detail. See Stephen S. Ashley, *Extrinsic Facts and the Duty to Defend*, 9 *BAD FAITH L. REP.* 197, 201 (1993) (examining California decisions and arguing that it is unsound to hold that an insurer has a duty to defend if facts having no bearing on the insured's liability ultimately establish that the policy provides no coverage); William T. Barker, *Dissident Thoughts on the Duty of Defense*, 9 *BAD FAITH L. REP.* 115, 115-16 (1993) [hereinafter Barker, *Dissident Thoughts*] (arguing that the insurer's status as a co-client of the insured's counsel, and the insurer's contractual right to select counsel and control the defense, should render it vicariously liable for the defense counsel's blunders); William T. Barker, *When Does the Insurer Lose the Right to Control the Defense?*, 58 *DEF. COUNS. J.* 469, 481 (1991) [hereinafter Barker, *When Does the Insurer Lose*] (analyzing the insurer's control of the defense in a case of conflict of interest); James M. Fischer, *Broadening the Insurer's Duty to Defend: How Gray v. Zurich Insurance Co. Transformed Liability Insurance into Litigation Insurance*, 25 *U.C. DAVIS L. REV.* 141, 146-49 (1991) (explaining the origin of the insurer's duty to defend); Susan Randall, *Redefining the Insurer's Duty to Defend*, 3 *CONN. INS. L.J.* 221, 222 (1997) (ar-

bility policies—including auto, homeowners', and commercial general liability—give the insurer both the right and the duty to defend any lawsuit that seeks damages covered under the insured's policy, no matter how groundless the suit may be.<sup>9</sup> With our liability insurance premiums, then, we purchase two connected but distinct protections: a promise to pay on our behalf—up to the policy limits—if we are found liable (“indemnity insurance”),<sup>10</sup> and a promise to provide a defense regardless of how justified the lawsuit is, and regardless of how much that defense costs (“defense insurance”).<sup>11</sup> Usually, the promise to defend is not directly capped by the policy limits; for example, the insurer on a \$50,000 liability policy must provide a defense, whether the defense costs five thousand dollars, one hundred thousand dollars, or more. In addition, the defense obligation often exists even when it is doubtful that the insurer will owe a duty to pay for the injury that is the subject of the lawsuit.<sup>12</sup>

The contours of defense insurance have key implications for the tort system. First, whether and on what terms potential defendants can obtain insurance against defense costs are issues that bear on the

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going that “a liability insurer’s duty to defend arises only if the policy covers the conduct at issue in the litigation against the insured”); Alan I. Widiss, *Abrogating the Right and Duty of Liability Insurers to Defend their Insureds: The Case for Separating the Obligation to Indemnify from the Defense of Insureds*, 51 OHIO ST. L.J. 917, 919 (1990) (arguing that the obligation to indemnify should be separated from the duty to defend in insurance agreements). Practical commentators and continuing legal education programs in recent years have addressed both the duty to defend and the collateral disputes that arise as a result of the duty. See, e.g., LITIGATING THE COVERAGE CLAIM: DENIAL OF COVERAGE & DUTY TO DEFEND (A.B.A., Tort & Insurance Practice Section, 1992) (presenting papers addressing the practical issues facing litigators in disputes about insurance coverage); Robert R. Reeder, *The Duty to Defend*, Address at Insurance: Third Party Liability Seminar sponsored by The Defense Research Institute, Inc. (Mar. 11-12, 1993) (addressing the scope and the parameters of the duty to defend).

9. See ALLIANCE OF AMERICAN INSURERS, POLICY KIT FOR INSURANCE PROFESSIONALS 198, 201 (1993-94) (reprinting a standard commercial general liability policy formulated by the Insurance Services Office and providing that “[w]e will have the right and duty to defend any ‘suit’ seeking those damages”); *id.* at 29 (reprinting a standard homeowners’ policy providing that “we will [p]rovide a defense at our expense by counsel of our choice”).

10. See *id.* at 201 (reprinting a standard commercial general liability policy providing that “[w]e will pay those sums that the insured becomes legally obligated to pay as damages because of ‘personal injury’ or ‘advertising injury’ to which this coverage part applies”). According to policy language, only settlements approved by the insurer constitute covered liabilities. *Id.* at 206 (providing that the insurer may be sued to recover the amount of an agreed judgment, but defining “agreed judgment” as “a settlement and release of liability signed by us, the insured and the claimant or the claimant’s legal representative”).

11. See *infra* text accompanying notes 85-92 (describing the basic rules about the duty to defend).

12. See *infra* text accompanying notes 85-92.

justice and efficiency goals of the tort system.<sup>13</sup> Second, under most insurance arrangements, the insurer's obligation to defend is not entirely distinct from its obligation to pay the ultimate tort judgment or settlement. Instead, in complex and often misunderstood ways, the defense question—"Must the insurer provide a defense in this case?"—very much affects another question—"Will the injured tort plaintiff receive any compensation in this case?"<sup>14</sup> To some degree, moreover, the strategic behavior of the parties to the tort litigation influences the link between defense insurance and compensation for injury.<sup>15</sup> Thus, the structure of the defense obligation implicates issues of compensation, systematically affects the litigation strategies and settlement choices of parties to tort litigation, and bears on the efficiency of the tort system. Third, the insurer's obligation to defend creates a host of thorny professional responsibility issues for the insurance defense counsel,<sup>16</sup> and gives rise to much ancillary litigation relating to professional responsibility, the insurer's negligence or bad faith in not defending, and the manner in which the insurer conducted the defense.<sup>17</sup>

A careful look at the defense obligation and its connection to the tort litigation system is especially timely because the nature and scope of the obligation have become increasingly contested terrain in recent years.<sup>18</sup> Several factors have contributed to this change. First, the scope, length, and expense of much modern tort litigation have raised

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13. Cf. Schwartz, *supra* note 2, at 325 (explaining that liability insurance promotes fairness by allowing insureds to protect themselves against the unreliability of the civil justice system).

14. See *infra* text accompanying notes 70-79 (explaining how the duty to defend affects the likelihood and amount of compensation to the plaintiff).

15. See *infra* text accompanying notes 154-158, 161-164.

16. For a recent entry in the extensive scholarship on these issues, see Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 263 (1995) (exploring the nature of the relationship between insurance defense counsel, the insurer, and the insured). See generally ROBERT E. KEETON & ALAN I. WIDISS, *INSURANCE LAW* § 7.6, at 809-10 (1988) (identifying conflicts of interest concerning, for example, the insurer's requirements, insured's requests, and the roles, rights, and responsibilities of the insurer and the insured); Symposium, *Liability Insurance Conflicts and Professional Responsibility*, 4 CONN. INS. L.J. 1 (1998).

17. See ROBERT H. JERRY, II, *UNDERSTANDING INSURANCE LAW* §§ 111[g], 111[h], 114 (2d ed. 1996) (discussing, respectively, insurer's liability for inadequate defense, remedies for breach of duty to defend, and conflicts of interest in insurance defense representations); Kenneth S. Abraham, *The Natural History of the Insurer's Liability for Bad Faith*, 72 TEX. L. REV. 1295, 1295-96 (1994) (analyzing the history of the growth of bad faith liability claims against insurers since the 1970s).

18. See JERRY, *supra* note 17, § 111[e], at 750 (observing that the nature and scope of the duty to defend remain controversial for courts).

the stakes for defense insurance.<sup>19</sup> Measures of defense costs over the past fifteen years have indicated that an increasing percentage of total liability insurance payments—as much as forty-one percent—is attributable to defense costs.<sup>20</sup> These increased costs, in turn, affect the number of disputes over the defense obligation. Because insurers are not obligated to defend every lawsuit, but only a lawsuit laying out a potentially covered theory of liability,<sup>21</sup> insurers have always decided not to defend some lawsuits.<sup>22</sup> But the spectre of massively expensive litigation plays a part in the calculation. When the costs of defense are relatively small, an insurer that doubts its duty to defend nonetheless might find it cost-efficient to fund the defense. Yet, harboring no greater a doubt, but facing litigation far more costly, an insurer might decide that denying a defense is the most cost-efficient option.

Second, plaintiffs' lawyers have discovered that defense insurance can be their ally, not their enemy. The point might seem counterintuitive. One would suppose that plaintiffs' lawyers are happy to see potential funding for a tort judgment, but are less pleased that the insurer is the opponent, in light of the latter's resources and abilities as a repeat litigator. Yet the duty to defend is often a doorway into some payment for the tort victim. This doorway was never a secret one, but in recent years it has widened and become more visible. Plaintiffs' lawyers often plead lawsuits in a way designed to trigger a duty to defend even when there is quite likely no ultimate indemnity coverage.<sup>23</sup> The hope is that, either by misstepping or consciously deciding to settle, the insurer will cover at least part of the tort liability.

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19. See INSURANCE SERVICES OFFICE, INC., LEGAL DEFENSE: A LARGE AND STILL GROWING INSURANCE COST 4 (1991) (reporting that, in 1991, defense costs for the casualty lines of insurance amounted to \$15 billion or 14% of the total insured losses for those lines of insurance). Insurers have responded to rising costs with a number of cost-control devices, including outside auditing of legal bills, flat-fee or bundled-fee arrangements, and the use of "staff counsel" operations to defend suits. See Charles Silver, *Flat Fees and Staff Attorneys: Unnecessary Casualties in the Continuing Battle over the Law Governing Insurance Defense Lawyers*, 4 CONN. INS. L.J. 205, 256 (1997) (defending the use of flat fees and staff counsel as necessary to the freedom of clients and lawyers to enter into consensual relationships). In the mid-1980s, the Insurance Services Office, a trade organization that prepares policy forms and helps obtain regulatory approval, sought to modify the standard commercial general liability policy so that defense costs would be included within the limits of the policy. See Kathryn J. McIntyre, *ISO Head Urges Including Defense Costs in Policy Limits*, BUS. INS., May 20, 1985, at 1. Eventually, the effort was dropped, partly in the face of regulatory doubts about the proposal. See JERRY, *supra* note 17, § 111[j], at 762.

20. JERRY, *supra* note 17, § 111[j], at 762 n.143.

21. *Id.* § 111[a], at 729.

22. *Id.*

23. See Ellen S. Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721, 1729-35 (1997) (explaining why plaintiffs' lawyers have reason to underlitigate intentional harm cases as involving only negligence).

This Article focuses on several core questions about the structure of the defense obligation. As suggested by cryptic policy language and as currently interpreted by the courts, the defense obligation often exists even when there is doubt that the policy provides indemnity coverage for the injury that forms the basis of the lawsuit against the insured. The insurer must defend the suit if the plaintiff alleges a claim that *might* be covered, even if facts suggest that the claim is not covered.<sup>24</sup> No other form of insurance has this structure. Why does this asymmetry between defense insurance and indemnity insurance exist? Is it efficient in terms of deterrence and loss-spreading, and, if not, why has the marketplace not responded? Even if this asymmetry is efficient in theory, is the defense obligation implemented in a way that is consistent with the fairness and efficiency objectives of the tort insurance regime? An answer to this latter question, in turn, requires addressing several doctrinal questions. When is the insurer obligated to defend if coverage for the underlying harm is doubtful? May the insurer escape the defense obligation once it has assumed it? Should courts allow simultaneous litigation in separate courts of the defense obligation and the tort suit?

How these questions are answered has a direct bearing on the effects noted earlier—the justice and efficiency of defense insurance, the extent to which defense insurance becomes translated into payment to the tort victim, and the extent and nature of ancillary litigation relating to professional responsibility and the insurer's obligations. Neither the marketplace nor the body of insurance doctrine currently provides satisfying answers to these questions. For reasons discussed below, insurance contracts do not answer these questions, and the marketplace has not responded with policy modifications that settle these issues.<sup>25</sup> Judicially created standards address the defense obligation in great detail, but in many jurisdictions the resulting doctrines remain unclear, unstable, or unsatisfying.<sup>26</sup>

Part I examines the theoretical structure of defense insurance. It explains why and on what terms insurers and insureds, respectively, are willing to sell and buy it; why it is so commonly bundled with indemnity insurance; and why the coverage scope of defense insurance,

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24. See *infra* notes 85-94 and accompanying text (discussing current tests for deciding if the insurer owes a duty to defend).

25. See *infra* text accompanying notes 43-49.

26. See *infra* notes 90-92 (identifying jurisdictions in which simultaneous adjudication of the defense obligation and the tort suit has been either barred, permitted, or not yet settled).



although not identical to that of indemnity insurance, is closely similar to it.

Part II more closely examines the decisional structure of defense insurance. It addresses why courts universally view this insurance as having a different decisional structure than other forms of first-party insurance.<sup>27</sup> Two features mark this structure. First, at least at the outset of a lawsuit against the insured, the defense obligation, unlike other insurance, turns not on the actual facts relating to coverage, but on what the tort plaintiff alleges in the lawsuit against the insured—the so-called complaint allegation rule.<sup>28</sup> Second, courts often will not allow a declaratory judgment proceeding that seeks to adjudicate the defense obligation while the underlying suit against the insured is still pending.<sup>29</sup> Thus, an insurer that contests its duty to defend often cannot litigate this issue in a declaratory judgment, but instead must continue to provide a defense according to the complaint allegation rule.

Although most courts agree with these two features, important jurisdictional differences remain.<sup>30</sup> Some jurisdictions remain unsettled about the appropriate standards. Not until 1993, for instance, did the California Supreme Court, in *Montrose Chemical Corp. v. Superior Court*,<sup>31</sup> resolve extensive and conflicting previous authority relating to the decisional structure of the duty to defend. A number of other jurisdictions have not yet settled on stable rules in this area.<sup>32</sup>

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27. First-party insurance refers to insurance arrangements under which the insurer pays the proceeds, if due, to the insured or the insured's designated beneficiary. Third-party insurance refers to arrangements under which the insurer pays someone injured by the insured's conduct. See KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* 175 (1986) (discussing this distinction in the context of legal regulation of the claims process). Thus, although defense insurance is bundled within a policy of liability insurance, it is first-party insurance.

28. See *infra* notes 86-89 and accompanying text (discussing the complaint allegation rule).

29. See *infra* notes 90-92 and accompanying text (discussing the range of judicial approaches to declaratory judgment actions involving overlapping facts); *infra* notes 177-181 (discussing the range of judicial approaches to declaratory judgment actions involving nonoverlapping facts).

30. See *infra* notes 90-92 and accompanying text; *infra* notes 177-181.

31. 861 P.2d 1153 (Cal. 1993) (in bank). See generally Paula L. Harrington, Note, *The Duty to Defend in California After Montrose Chemical Corp. v. Superior Court: Is the California Supreme Court Protecting Policyholders or Encouraging Litigation and the Early Settlement of Unworthy Claims?*, 31 CAL. W. L. REV. 165, 165-67 (1994) (examining the implications of the *Montrose* decision for policyholders).

32. See *infra* text accompanying notes 90-92 (discussing various jurisdictional approaches to the duty to defend in overlapping cases); text accompanying notes 177-181 (discussing various jurisdictional approaches to the duty to defend in nonoverlapping cases).

Thus, both features of the decisional structure should be examined in light of the systemic aims of insurance and tort law. To do so, it is necessary to distinguish between two types of cases: cases in which the insurer's coverage argument does not overlap with the issues at stake in the underlying tort suit, and cases in which such an overlap exists. Turning first to overlapping scenarios, Part II argues that the insurer's obligation in such cases should have a different decisional structure than other forms of insurance. The complaint allegation rule ought to govern, and the insurer generally should not be allowed to contest its defense obligation on the basis of the actual facts in a declaratory judgment suit.

Part III turns to the nonoverlapping scenario, and argues that in these cases the defense obligation should be given the same decisional structure as other forms of first-party insurance. Thus, an insurer should not be required to follow the complaint allegation rule, and generally should be permitted to pursue a declaratory judgment action using the actual facts relating to coverage.

## I. THE THEORETICAL STRUCTURE OF DEFENSE INSURANCE

The most interesting and complex issues posed by the defense obligation—including the effects it has on the strategies of the parties to tort litigation—arise because defense insurance may be available in a given case even when indemnity insurance is not.<sup>33</sup> To address these issues, we need to understand the relationship between defense insurance and indemnity insurance. Why is defense insurance bought and sold? To what extent do efficiency and fairness considerations require that the scope of defense insurance be linked to the scope of indemnity insurance? This Part addresses these questions. This will allow a discussion, in Parts II and III, of the proper decisional structure for the duty to defend.

### A. *Why Litigation Insurance Is Bought and Sold*

In explaining the demand for litigation insurance, the starting point is the value of a defense.<sup>34</sup> Defendants spend money on a defense because the provision of a better or worse defense can affect a case's outcome. Because a defense is valuable, a rational individual or corporation would anticipate having to pay for a defense in the event

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33. See JERRY, *supra* note 17, § 111[a], at 730 (explaining that the duty to indemnify is much narrower than the duty to defend, because the latter includes even meritless suits that on their face are covered by the policy).

34. See generally Fischer, *supra* note 8, at 146-50 (providing a historical account of the duty to defend).

of suit. Thus, an individual or corporation can anticipate that a lawsuit will impose two potential losses: the judgment amount (if any) that the individual will have to pay; and the costs of defending the suit.

Defense costs, then, are simply another type of loss to which the insured might be exposed. Importantly, this loss, like the cost of liability for the underlying harm itself, is uncertain in frequency and magnitude. The costs of defense might be relatively small in a given case, or might be enormous. Standard economic analysis teaches that individuals are generally risk averse; that is, they care not just about the expected value of a loss, but also about the magnitude of the loss in relation to their wealth.<sup>35</sup> For instance, an individual will prefer a certain loss of \$2000 over a ten percent chance of losing \$20,000, notwithstanding that both scenarios have the same expected value. Thus, an individual will be willing to incur the cost of insurance premiums in exchange for a guarantee that, should the insured loss arise, she will be protected from that loss.<sup>36</sup>

The analysis of corporate demand for insurance is more complex. Defense insurance is a component of the commercial general insurance policy purchased by many small and large American firms, as well as a number of other standard commercial line policies, such as

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35. See ABRAHAM, *supra* note 27, at 11-12 (discussing basic incentives to purchase insurance); SHAVELL, *supra* note 2, at 186-93 (explaining why individuals and firms will wish to purchase insurance to cover future losses whose magnitude is uncertain); Georges Dionne & Scott E. Harrington, *An Introduction to Insurance Economics*, in FOUNDATIONS OF INSURANCE ECONOMICS 1, 3-6 (Georges Dionne & Scott E. Harrington eds., 1992) (discussing expected utility as a tool in insurance analysis). While the expected utility framework remains an essential tool in understanding insurance relationships, considerable literature now demonstrates that individual choices about risks and uncertainties deviate from the rational choice model as a result of biases, the framing of choices, and other factors. See Colin Camerer & Howard Kunreuther, *Making Decisions About Liability and Insurance: Editors' Comments*, 7 J. RISK & UNCERTAINTY 5, 7-8 (1993); Eric J. Johnson et al., *Framing, Probability Distortions, and Insurance Decisions*, 7 J. RISK & UNCERTAINTY 35, 48-49 (1993); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 3, 3 (Daniel Kahneman et al. eds., 1982) (setting forth the heuristic principles on which people rely to assess the probability of uncertain events).

36. See ABRAHAM, *supra* note 27, at 11-12 (discussing insurance law and economic efficiency); SHAVELL, *supra* note 2, at 187-93 (analyzing risk aversion and the allocation of risk). Under the standard economic account, risk aversion is the consequence of the diminishing marginal utility of income: "It should seem plausible that a party for whom [increased wealth has diminished marginal utility] will especially dislike bearing the risk of large losses, for such losses will evidently matter to him disproportionately in terms of utility." *Id.* at 187. The risk aversion that motivates the purchase of liability insurance also is likely to flow from psychological considerations. See Schwartz, *supra* note 2, at 322 & n.39 (discussing, in light of psychological studies, how insurance converts possible losses into more psychologically acceptable events).

boiler, machinery, and commercial auto.<sup>37</sup> To some extent, corporate purchases of insurance can be explained by aversion on the part of managers, or employees whose jobs are linked to the company's performance, to the possibility of enormous defense bills.<sup>38</sup>

Insurers are willing to sell defense insurance for two reasons. The first follows from standard insurance analysis. Given sufficient numbers of similar, uncorrelated, and otherwise insurable risks, an insurer can take advantage of the law of large numbers to predict the aggregate risk and calculate premiums on that basis.<sup>39</sup> This analysis also applies to the risk that an insured will be sued and that litigation costs will be incurred.

A second reason concerns the indemnity portion of the liability insurance contract. Because insurers promise to pay any damages (up to the policy limit) for which the insured might be legally liable, the insurer has a powerful incentive to control the defense of the lawsuit.<sup>40</sup> Were the insurer to abstain from any role in the defense, then the insured would be free to settle or defend the case as she saw fit. Even if the insurance contract or a court required the insured to act "reasonably" in this respect, the insurer might fear that this standard would not give an adequate incentive to the insured to engage in a vigorous defense, settle for a reasonable amount, or keep the defense tab within acceptable limits.<sup>41</sup> Insureds also benefit from the insurer's

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37. See ALLIANCE OF AMERICAN INSURERS, *supra* note 9, at 198 (reprinting commercial general liability policy with duty to defend); *id.* at 150 (reprinting boiler and machinery policy with duty to defend); *id.* at 223 (reprinting business auto insurance policy containing duty to defend).

38. See SHAVELL, *supra* note 2, at 189-90 (discussing the importance of risk aversion with regard to individuals and firms). Other factors include the loss prevention and reduction services that insurers provide, and the fact that corporations might be required to show proof of insurance coverage as a condition to certain business transactions. See Pottier & Witt, *supra* note 1, at 1684. For further discussion of corporate demand for insurance, see David Mayers & Clifford W. Smith, Jr., *On the Corporate Demand for Insurance*, 55 J. BUS. 281, 281-82 (1982) (arguing that the corporate demand for insurance is not adequately explained as risk aversion, but as part of the firm's financing policy with respect to taxes, contracting costs, or the impact of financing policy on the firm's investment decisions).

39. See GEORGE E. REJDA, PRINCIPLES OF RISK MANAGEMENT AND INSURANCE 24-26 (4th ed. 1992) (explaining the need for large numbers of insureds in the calculation of insurable risk); Bovbjerg, *supra* note 1, at 1656 (discussing the relationship of risk, risk aversion, and liability insurance); Patricia M. Danzon & Scott E. Harrington, *The Demand for and Supply of Liability Insurance*, in CONTRIBUTIONS TO INSURANCE ECONOMICS 25, 26 (Georges Dionne ed., 1992) (discussing the literature on the supply and demand for liability insurance with attention to the relationship between liability law, liability insurance, and risk reduction).

40. JERRY, *supra* note 17, § 111[a], at 731.

41. See Charles Silver, *Does Insurance Defense Counsel Represent the Company or the Insured?*, 72 TEX. L. REV. 1583, 1595-96 (1994) (suggesting reasons why the insurer will want the right to defend and will demand exclusive control of the defense).

expertise in managing litigation, including the selection of competent counsel, monitoring of counsel, and skill in bargaining and trial strategy.<sup>42</sup>

This second reason helps explain several features of the current defense insurance marketplace. First, indemnity and defense insurance are bundled together in standard policy lines. In theory, insureds could purchase defense insurance from one insurer and indemnity coverage from another. Indeed, this would help reduce many problems generated by bundling the two together, particularly conflicts of interest for insurance defense counsel.<sup>43</sup> Yet the marketplace has not responded by adopting or pushing for an unbundled approach.<sup>44</sup> In the mid-1980s, insurers sought regulatory approval of policies that would apply a single policy limit to both the costs of indemnity and the costs of defense.<sup>45</sup> But these efforts stalled, in part as a result of regulatory objections.<sup>46</sup> By contrast, insurers apparently have not even sought regulatory approval in any widespread manner for unbundled indemnity and defense insurance in standard policy lines. The lack of a marketplace response to this obvious alternative is a powerful testament to the mutual advantages of linking insurer control over the defense with the insurer's indemnity obligation.

These same considerations help explain a second salient feature of the current defense insurance marketplace. Although the duty to defend is bundled with indemnity insurance in standard individual policies and in the commercial general liability policy purchased by thousands of American firms, this is not a universal feature of corpo-

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42. See William T. Barker, *Insurance Defense Ethics and the Liability Insurance Bargain*, 4 CONN. INS. L.J. 75, 79 (1998) (noting that, because insurers are in the business of managing litigation, they must be efficient and minimize costs or risk losses); Silver, *supra* note 41, at 1596.

43. For an argument advocating complete separation of defense insurance from indemnity insurance, see Widiss, *supra* note 8, at 945.

44. Apparently, some individuals within the insurance industry began in the early to mid-1980s to seek limits on defense costs or elimination of the defense obligation from standard policies, but this was met with objections from risk managers, agents, and brokers. Telephone Interview with Sean Mooney, Actuary at Insurance Services Office (Sept. 22, 1995). See also Richard S.L. Roddis, *Control of Legal Expenses—The Greatest Current Challenge*, Address Before the National Association of Independent Insurance Adjusters 13-14 (May 1, 1986) (arguing for redrafting of standard commercial general liability policies to eliminate the insurer's duty to defend while still reserving its right to defend).

45. See McIntyre, *supra* note 19, at 1, 34 (discussing efforts by Insurance Services Office to draft and obtain regulatory approval of commercial general liability forms that include defense costs within the indemnity limits of the policy); see also JERRY, *supra* note 17, § 111 [j], at 762 (discussing these efforts).

46. See Shaun M. Baldwin, *Legal and Ethical Considerations for "Defense Within Limits" Policies*, 61 DEF. COUNS. J. 89, 89-90 (1994) (describing insurance regulators' opposition to "defense within limits" policies).

rate insurance. Many corporations carry a large deductible or self-insured retention, and purchase insurance only for exposure in excess of the deductible or self-insured retention.<sup>47</sup> Such policies often provide that the insurer has no duty to defend the claim, although the policies may give the insurer certain rights to participate in or approve of defense or settlement decisions.<sup>48</sup> These arrangements are understandable in light of the considerations just noted. These insured entities, unlike small firms or individuals, are often repeat litigators with in-house legal staff that can effectively manage and monitor litigation. In addition, the insured's retention of a considerable level of liability exposure helps protect the insurer from the risk that the insured will fail to defend the case vigorously or will settle the case for an unreasonable sum.<sup>49</sup>

These points help explain why defense insurance is so commonly sold and purchased, and why it is ordinarily bundled with indemnity insurance. But what is the optimal link between indemnity and defense coverage, and do policies in practice contain this type of link? The next subpart takes up these questions.

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47. For discussion of excess insurance over self-insured retentions, as well as other insurance arrangements that allocate risk differently than standard policies, see William T. Barker, *Combining Insurance and Self Insurance: Issues for Handling Claims*, 61 DEF. COUNS. J. 352, 352-55 (1994); Syverud, *supra* note 4, at 1201-07.

Certain policies, such as those covering directors' and officers' liability, do not contain separate defense insurance uncapped by policy limits. Instead, under these policies the total policy limits apply to both indemnity costs and defense costs, and the insured provides its own defense. See ALLIANCE OF AMERICAN INSURERS, *supra* note 9, at 420-23 (reprinting directors' and officers' liability policy in which "loss" is defined to include indemnity payouts and defense costs, and under which the insurer has no duty to defend the insured).

48. Such policies are not highly standardized. See, e.g., *North Am. Van Lines, Inc. v. Lexington Ins. Co.*, 678 So. 2d 1325 (Fla. Dist. Ct. App. 1996). The insured had a deductible of \$1 million, and policies covering, respectively, exposure from \$1 to \$5 million, and \$5 to \$20 million; the policy for the first excess layer provided that "[t]he [Insurer] shall not be called upon to assume charge of the defense or settlement of any claims made or suits brought or proceedings instituted against the Insured." *Id.* at 1329. But the policy also provided that the insurer "shall have the right and shall be given the opportunity to associate with the Insured in the defense and control of any claim," and shall have "the right to assume complete control of any claim," if the claim appears to implicate the insurer's limit of liability under the policy. *Id.*

49. This is not to say that the arrangement aligns perfectly the interests of insureds and insurers. Particularly in recent years, disputes between insureds and excess insurers have ripened into litigation over issues relating to control and management of litigation and reasonable settlement conduct. See, e.g., *id.* at 1325.

*B. The Content of Litigation Insurance: Theory and Practice*

To sketch the optimal structure of litigation insurance, it is helpful first to address the scope of the indemnity coverage on which rational parties would agree. Generally, a risk-averse insured would seek to purchase indemnity insurance that includes all the categories of conduct that might expose the insured to the risk of liability.<sup>50</sup> If the insured faces a risk of liability for polluting the environment, the insured will seek indemnity insurance for that risk, and likewise for other types of liability risks that the individual faces, such as defamation or negligence.

On the other hand, insureds often would agree to certain exclusions in the indemnity coverage. They would agree to any exclusion relating to an activity or risk that the insured can be confident does not apply to her. For instance, an individual homeowner would agree to an exclusion for any liabilities arising out of business uses of the premises. If she knows that she does not use the premises in connection with any business, she can be fairly certain that she will never be subject to a business-related liability for this site. Thus, she would be willing to agree to an exclusion in exchange for the lower premium that the insurer will charge her as a result. Some very important indemnity exclusions, such as those for products liability and business risks, can be explained on this basis.<sup>51</sup>

This demand-side analysis explains some common indemnity exclusions, but not all. Some indemnity exclusions stem mainly from supply-side considerations. Insurers might decide that a risk is too difficult to predict,<sup>52</sup> that adverse selection with respect to this risk will be too great,<sup>53</sup> or that the risk is too highly correlated.<sup>54</sup> Supply-side

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50. Cf. SHAVELL, *supra* note 2, at 193 (explaining that policies providing full coverage against potential loss are optimal). Although full coverage appears optimal, the very fact that an activity is covered by insurance might increase the chances that an individual will be sued, and the purchase of higher indemnity amounts might increase the size of judgments or settlements. For discussion of these possibilities, see Bovbjerg, *supra* note 1, at 1655-70 (questioning Syverud's thesis that insurance drives liability and increases tort awards and settlements); Syverud, *supra* note 1, at 1633-49 (proposing that liability insurance expands tort liability in various ways). An individual with few collectible assets, then, might rationally choose to go without insurance, or with low limits, on the theory that this will lessen the chances of a suit.

51. Cf. Pryor, *supra* note 23, at 1741 (noting that an individual insured would agree to an exclusion for products liability because he faces no risk of such liability).

52. See REJDA, *supra* note 39, at 25-26 (explaining that insurers must be able to calculate risks in order to set appropriate premiums).

53. Adverse selection occurs when potential insureds know more than the insurer about their expected insured loss, even after the insurer gains information about the insured through the underwriting process. Insureds possessing this asymmetrical information will purchase insurance that is priced on the basis of the average risk posed by a

considerations probably explain the pollution exclusion in standard individual and commercial lines.<sup>55</sup>

Other exclusions result from a blend of demand and supply considerations. This is the likely explanation for the most important standard exclusion, the exclusion for losses caused intentionally by the insured.<sup>56</sup> From the insurer's perspective, intentionally controlled losses are, in the main, not actuarially predictable, and they pose moral hazard and adverse selection problems that further undermine their insurability.<sup>57</sup> From the insured's perspective, too, the purchase of insurance for such losses might not be sensible. For most insurance purchasers, it would be cheaper to engage in prevention activities—that is, to avoid intentionally harmful behavior—than to purchase insurance for it, even if such insurance could be purchased at an actuarially fair price.<sup>58</sup> In addition, although individuals rationally purchase insurance against the possibility of erroneous liability findings, insureds could plausibly decide that an erroneous jury finding of intentional harm is less likely than an erroneous finding of negligence.<sup>59</sup>

In sum, the insured would seek to purchase liability-indemnity insurance against all categories of risk into which the insured's activities fall. But this is not to say that the liability-indemnity insurance will cover every category of risk. The insured would agree to exclusions as

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particular pool of insureds. The insurer, in turn, will have made this pricing decision on the assumption that the insured pool will eventually contain some insureds who pose a lower-than-average risk and some who pose a higher-than-average risk. Because this insurance will be attractively priced to those insureds who know they are high risk, they will enroll in higher number than the insured assumed when setting the price. See ABRAHAM, *supra* note 27, at 15; Hanson & Logue, *supra* note 3, at 140 (explaining the formation of insurance pools based on the riskiness of the insured).

54. See REJDA, *supra* note 39, at 25 (noting that one criterion of an insurance risk is that a given event not cause losses simultaneously to too many insureds).

55. See ABRAHAM, *supra* note 27, at 46-51 (explaining the difficulties of accurately predicting the risks related to toxic substances, and describing the problems this creates for insurability).

56. See Pryor, *supra* note 23, at 1741-43 (discussing reasons why both insurers and insureds would agree to exclude coverage for intentional harms).

57. See *id.* at 1742 (explaining that the risks from intentional acts do not conform to the law of large numbers); Samuel A. Rea, Jr., *The Economics of Insurance Law*, 13 INT'L REV. L. & ECON. 145, 155-58 (1993) (commenting that insurers will not cover intentional acts due to the moral hazard inherent in doing so).

58. See Pryor, *supra* note 23, at 1742 (discussing the benefit to insureds of not insuring liability for harm produced intentionally by the insured).

59. See George L. Priest, *Insurability and Punitive Damages*, 40 ALA. L. REV. 1009, 1026 (1989) (noting that risks associated with intentional harms are not likely to be realized); Pryor, *supra* note 23, at 1742 (suggesting that erroneous findings of intentional tort liability might be less common than erroneous findings of negligence).



to any risks not potentially created by the insured's activities; the insurer will insist on exclusions for risks that are not deemed insurable.<sup>60</sup>

Turning to the content of litigation insurance, one feature is obvious. A potential insured seeking defense insurance would not want this coverage to turn on whether or not the suit filed against the insured has merit. For instance, while an insured employer might anticipate that it will be subject to a number of meritless sexual harassment claims, it still will desire insurance against the costs of that litigation, regardless of its merits.

In practice, litigation insurance contains this feature. According to the language of standard policies,<sup>61</sup> and under insurance doctrine that courts universally follow, an insurer is not allowed to deny a defense solely because it believes that the suit against the insured lacks merit.<sup>62</sup>

The more difficult topic is whether and what sorts of exclusions would be optimal for defense insurance. The first issue is whether the optimal defense insurance coverage would contain any exclusions, or would instead extend to any type of litigation filed against the defendant. Some exclusions would be desirable from the insured's perspective. For instance, consider a possible exclusion for business uses of a boat. The insured, recall, does not desire indemnity insurance for business uses because either: (1) the insured does not expect ever using the boat for such purposes; or (2) the insured will be covered by her employer's own insurance if the boat is involved in an accident while being used in connection with business.<sup>63</sup> For these same reasons, the insured will not want defense insurance to extend to situations in which the boat was being used for business purposes. She would have to pay an added premium for coverage that she does not anticipate needing.

Some exclusions to defense insurance, then, are optimal. But would the exclusions in defense insurance mirror those in indemnity insurance? For instance, if the indemnity insurance excludes business uses, products liability, pollution, and intentional harm, would these

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60. In a similar vein, an insurer might be willing to offer coverage for a certain risk, but only at a price that is excessive relative to the actuarially fair price. The result will be a choice by the insured not to purchase that coverage, and a resulting policy exclusion for that coverage. See Pryor, *supra* note 23, at 1743 (stating that even those people at a high risk of harm from certain risks would not be willing to pay excessively high premiums).

61. See *infra* text accompanying notes 82-84 (providing examples of the relevant standard policy language).

62. See JERRY, *supra* note 17, § 111[a], at 729.

63. See *supra* text accompanying notes 50-51.

same exclusions apply to defense? Consider first the exclusions that stem from demand-side considerations, such as business uses or products liability.<sup>64</sup> For the same reasons that the insured would accept these exclusions for indemnity insurance, the insured also would accept these exclusions for defense insurance. When the exclusion stems mainly or partly from supply-side considerations,<sup>65</sup> whether the same exclusion also would apply to defense insurance depends on whether the same supply-side difficulties extend to defense insurance. Often, this would be the case. For instance, many of the insurability problems associated with indemnity for pollution costs, such as adverse selection and predictability of the exposure, also apply to defense costs for litigation relating to pollution.<sup>66</sup>

Generally, litigation insurance in practice tends to fit this analysis. Standard policy language does not contain a separate list of exclusions for, respectively, defense and indemnity. Rather, the policy language invokes the same exclusions for both; the promise to defend extends to suits seeking damages "covered" under the policy.<sup>67</sup>

Having determined that defense insurance would contain exclusions, and that the exclusions would generally tend to mirror the exclusions to indemnity coverage, a further question remains. What is the optimal decisional structure for coverage questions under defense insurance? In all other forms of insurance, the answer to this is simple: whether or not the exclusion applies in a given case turns on the actual facts, not on what anyone alleges those facts to be. For instance, suppose that an insured under a disability policy submits a claim on June 1 to the insurer, contending that he has been disabled within the meaning of the policy since March 1. The insurer, after a brief investigation, denies the claim on July 1. The insured sues, and the case is litigated, resulting in a finding that the insured is not disabled within the meaning of the policy.

We have no trouble concluding that the insurer has not breached its obligations under the policy. No one would argue that the carrier's obligations are as follows: The insurer must assume the truth of the allegations set out in the claim filed June 1, and must begin to pay benefits unless and until the insurer obtains an adjudication that the

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64. See *supra* text accompanying note 51.

65. See *supra* text accompanying notes 52-59.

66. See ABRAHAM, *supra* note 27, at 46-47 (discussing the fact that toxic risks are difficult to predict actuarially because of uncertainty concerning chemical properties, the way in which hazardous waste migrates, and the scope of any given disaster). The frequency and, possibly, the length and complexity of suits against an insured for pollution are also difficult to predict.

67. See *infra* text accompanying notes 82-84 (quoting standard policy language).

insured is not in fact disabled within the meaning of the policy. Instead, everyone agrees that the insurer is free to make its decision based on its assessment of the true facts, or on its prediction about how the adjudication of the true facts will turn out.

Thus, the decisional structure that applies to most insurance obligations is marked by two features: (1) coverage turns on the actual facts; and (2) either party can seek an adjudication of those facts once a disagreement over coverage arises.

Suppose that defense insurance were structured this same way. If such insurance contained a business uses exclusion, or an intentional harm exclusion, then whether the insurer owed a defense would turn on whether, in fact, the injury occurred in conjunction with a business use or the insured caused the harm intentionally. Because this structure matches that seen in other insurance contexts, as a threshold matter one would expect to see a similar structure for defense insurance. Instead, however, courts overwhelmingly follow a very different approach, marked by two features: (1) whether the insurer owes a defense at the outset, when given notice of the suit, depends on the allegations of the lawsuit;<sup>68</sup> and (2) the insurer is often not permitted to seek an adjudication, in a separate declaratory judgment action, as to whether the exclusion applies.<sup>69</sup> As Part III will show, some versions of this approach are misguided. Yet, for reasons explained in Part II, considerations of efficiency and fairness support a different decisional structure for defense insurance than for other forms of insurance.

### C. *Why the Decisional Structure Matters*

It is important to understand why the decisional structure of defense insurance profoundly influences not just litigation over insurance policies, but also the tort litigation regime itself. Let us suppose that we are choosing between two rules for implementing the defense obligation: (1) the insurer must defend any time the plaintiff's pleading alleges a claim that, if true, might create a covered liability; the insurer cannot go behind the pleadings and escape the defense on the basis of the actual facts relating to coverage in the case; or (2) the insurer can avoid the defense on the basis of the actual facts relating to coverage, so long as the insurer proves to be correct on the cover-

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68. See *infra* text accompanying note 86.

69. See *infra* note 90 (citing cases that disallow simultaneous adjudication of the duty to defend in overlapping scenarios) and text accompanying notes 117-125 (discussing whether a simultaneous declaratory judgment action should be permitted in overlapping scenarios).

age issue. For several reasons, this choice will have important implications for the individual actors in this dispute and will systematically affect tort litigation and liability insurance costs over the long haul.

First, the choice between the rules affects whether the insurer will have reason to take defense costs into account in calculating the settlement value of the underlying suit. Under the first rule, even if the insurer believes it will ultimately prevail on the actual facts, the insurer will have to bear the costs of defense in the tort suit. For instance, suppose the expected value (given liability and damages) of the tort suit is \$50,000,<sup>70</sup> the chances that the insured will win on coverage are 10%, the costs of defending the suit will equal \$60,000, and the plaintiff submits a settlement demand of \$30,000. The insurer's expected indemnity payout is only \$5000 (10% times the expected damages of the case), but it will incur defense costs of \$60,000.<sup>71</sup> Thus, the insurer might rationally pay the plaintiff's demand. This response is possible even though the insurer has collected liability insurance premiums that take into account expected defense costs.<sup>72</sup>

Second, the choice between the rules will also enhance the settlement value of some cases in which coverage may be doubtful. Under

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70. The expected value of the case will be the aggregate of a series of potential outcomes—for example, a 10% chance of a verdict in the range of \$100,000, a 20% chance of a verdict in the range of \$60,000, etc. See George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 6-12 (1984) (setting out the model for deciding whether to litigate or settle based on the difference between an insurer's anticipated payout and the cost of defending an action).

71. In the example, the insurer anticipates that defense costs will equal this amount before the insurer can obtain an adjudication that the exclusion applies.

72. This point gains force from the general rule that, "if the insurer has a duty to defend with regard to any aspect of a lawsuit, it has a duty to defend with regard to every aspect of a lawsuit." 1 ALLAN D. WINDT, *INSURANCE CLAIMS AND DISPUTES* § 4.01, at 199 (3d ed. 1995). The rule stems from the fact that usually it is impossible for the insurer to provide a defense as to only one claim within the suit filed against the insured. See *id.* § 4.13, at 203 (explaining that sometimes costs for defense of covered and noncovered claims cannot be separated easily and that separate representation is not possible). Obviously, this rule magnifies the size of the prospective defense bill in a number of cases. At times, if the defense of the uncovered claim can be separated, both conceptually and practically, from the defense of the covered claim, courts have allowed insurers to seek an allocation and to pay only the defense costs of the covered claim. See *id.* § 4.13, at 201-04, 202 n.161; see also *Voorhees v. Preferred Mut. Ins. Co.*, 588 A.2d 417, 425 (N.J. Super. Ct. App. Div. 1991) (mentioning authority for allocation but deciding that the facts of the case would not permit it), *aff'd*, 607 A.2d 1255 (N.J. 1992). In addition, a growing body of authority supports an insurer's right to seek reimbursement of defense costs that can be allocated solely to claims as to which the insurer never owed a duty to defend. See *Buss v. Superior Court*, 939 P.2d 766, 778 (Cal. 1997) (discussing the elements necessary for reimbursement); William T. Barker, *Insurer Recoupment of Defense Costs* 8-22 (Oct. 9, 1997) (paper presented at University of Texas School of Law, Second Annual Insurance Law Institute). All of these rules affect the size of the defense bill that an insurer can anticipate paying in a given case, but the basic point in text remains the same.

the first rule, insurers more often will be obligated to provide a defense for some period of time during the underlying suit. This, in turn, means that insurers more often will be subject to the "duty to settle" that virtually all jurisdictions impose on insurers defending a case.<sup>73</sup> This duty is a justifiable response to concerns that the defending insurer will exercise its control over settlement inappropriately when its interests conflict with those of the insured.<sup>74</sup> Though variously framed among the jurisdictions, this duty usually requires the company to evaluate a within-limits settlement demand as if the policy contained no monetary limits.<sup>75</sup> If the company breaches this duty and the case results in a verdict against the insured higher than the policy's limit, the insurance company will be liable for the amount in excess of the policy's limit and possibly for mental anguish and punitive damages.<sup>76</sup> When the insurer rejects an otherwise reasonable settlement demand because of a coverage doubt, the insurer may be liable for breach of the duty to settle if its coverage position turns out to be mistaken.<sup>77</sup> Ex ante, of course, the insurer often cannot be certain, or even highly confident, of the outcome on the coverage issue. Thus, when faced with a within-limits settlement demand that is reasonable in light of the tort suit's potential liability and damages, the insurer might rationally decide to forego its coverage question and pay something to the tort plaintiff rather than risk a mistaken coverage call and potential duty-to-settle liability.<sup>78</sup>

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73. See I WINDT, *supra* note 72, § 5.01, at 295-96 & n.2 (discussing the duty to settle and citing supporting cases from various jurisdictions).

74. See ABRAHAM, *supra* note 27, at 188-93 (explaining the nature of the conflict of interest and the solution sought through the duty to settle); Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1137-48 (1954) (discussing the duty to settle). But see Sykes, *supra* note 4, at 1348 (questioning the need for extracontractual regulation of settlement authority); Syverud, *supra* note 4, at 1125-67 (discussing the sources of conflicts in settlements and the effects of the duty to settle).

75. See JERRY, *supra* note 17, § 112[b][1], at 765-67. This basic standard was first articulated by Judge Keeton, then Professor Keeton. Keeton, *supra* note 74, at 1183-86.

76. See JERRY, *supra* note 17, § 112[f], at 773-74.

77. If the insurer proves to be incorrect and coverage does exist, then the rejection of a reasonable demand within policy limits constitutes a breach of the duty to settle in a number of jurisdictions. See, e.g., *Johansen v. California State Auto Ass'n Inter-Ins. Bureau*, 538 P.2d 744, 748-49 (Cal. 1975) (in bank) (holding liable an insurer who failed to settle based on what it thought to be a reasonable belief that a claim was not covered). Other jurisdictions are somewhat more lenient and will impose duty-to-settle liability only if the insurer's mistake on the coverage issue was unreasonable. See, e.g., *Mowry v. Badger State Mut. Cas. Co.*, 385 N.W.2d 171, 175-85 (Wis. 1986) (ordering the dismissal of a case in which the insurer's failure to settle did not involve bad faith). Either way, the insurer might reasonably decide to pay something to the tort plaintiff rather than risk a mistaken coverage call and the resulting duty-to-settle liability.

78. See, e.g., Pryor, *supra* note 23, at 1733 (providing an example of a case in which the duty to settle may give some settlement value even to claims of doubtful coverage).

Third, the insurer often will not be allowed to litigate in a separate and simultaneous lawsuit the contention that, given the actual facts relating to coverage, the insurer owes no duty to defend. This means that the coverage issue is more likely to linger, unresolved, while the tort suit proceeds. As will be explained below, leaving the coverage issue unresolved throughout the tort litigation may have several effects: increasing the chances for structural collusion between the tort plaintiff and the tort defendant; increasing the number of tort cases that are tried rather than settled; increasing the level of insurance payments for harms that are and should be uninsured; and increasing the number of collateral disputes between insurer and insured, and insured and defense counsel.<sup>79</sup>

## II. MAPPING THE PROPER CONTOURS OF THE DUTY TO DEFEND: OVERLAPPING SCENARIOS

In light of the importance of the decisional structure for the duty to defend, we need to evaluate both the current structure and the possible alternatives to it. In addition to considering the language of standard policies and the interpretation that should be given to it, this analysis will draw on two normative aims of insurance law: efficient loss-spreading,<sup>80</sup> and fairness as between insurer and insured.<sup>81</sup>

Most standard commercial and individual liability policies contain language along the following lines:

We will pay damages for "bodily injury" or "property damage" for which any "insured" becomes legally responsible because of an auto accident. . . . We will settle or defend, as we consider appropriate, any claim or suit asking for these damages. In addition to our limit of liability, we will pay all de-

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79. See *infra* Part II.B.4 (discussing the difficulty with leaving the coverage issue unresolved during the tort litigation).

80. The tort-insurance system, in theory, can advance efficiency in two ways: by deterring accidents that, under a cost-benefit analysis, should be prevented (the deterrence goal), and by spreading the risks and costs of accidents that cannot be efficiently prevented (the spreading goal). See GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 26-31 (1970) (discussing deterrence and spreading goals). Insurance can promote efficient spreading because it allows individuals and corporations to transfer the risk of a large loss by paying smaller, certain sums of money—the insurance premium—to an entity that can more efficiently bear the risk. In evaluating the efficiency of various approaches to extrinsic evidence, the focus will be on spreading rather than deterrence because the rules relating to extrinsic evidence are unlikely to affect the level of deterrence that the system provides.

81. See ABRAHAM, *supra* note 27, at 8-36 (discussing the aims of insurance law, including economic efficiency, fair risk distribution, and equity between insurers and insureds). Whether to allow declaratory judgments using extrinsic overlapping evidence primarily implicates the two aims discussed above—loss-spreading and fairness between insurers and insureds.

fense costs we incur. . . . We have no duty to defend any suit or settle any claim for “bodily injury” or “property damage” not covered under this policy.<sup>82</sup>

If a claim is made or a suit is brought against an “insured” for damages because of “bodily injury” or “property damage” caused by an “occurrence” to which this coverage applies, we will: . . . Provide a defense at our expense by counsel of our choice, even if the suit is groundless, false or fraudulent.<sup>83</sup>

We will pay those sums that the insured becomes legally obligated to pay as damages because of “bodily injury” or “property damage” to which this insurance applies. We will have the right and duty to defend any “suit” seeking those damages.<sup>84</sup>

Notice that all versions tie the insurer’s obligation to what the plaintiff’s suit alleges or seeks, not to the substantive merit of the plaintiff’s allegations. The second is most explicit in this respect, given the “groundless, false, or fraudulent” clause, but the others also refer to the allegations or to what the plaintiff’s suit seeks.

With this language in mind, recall again that two features are critical to the decisional structure of defense insurance.<sup>85</sup> The first is the

82. ALLIANCE OF AMERICAN INSURERS, *supra* note 9, at 3 (reprinting personal auto policy).

83. *Id.* at 29 (reprinting standard homeowners’ policy).

84. *Id.* at 198 (reprinting claims-made commercial general liability policy).

85. In addition to the two structural features of defense insurance on which this Article focuses—the complaint allegation rule for determining whether coverage exists at the outset of the tort suit, and whether the insurer may adjudicate the duty to defend by means of extrinsic evidence in a simultaneous declaratory judgment action—there is another key structural question: whether the plaintiff should be able to name the insurer as a defendant in the tort suit. Most insurance policies provide a “no action” clause that disallows any action against the insurer until the insured’s liability has been established by a trial or a settlement approved by the insurer. *See id.* at 208 (reprinting a commercial liability policy containing such a clause). A common explanation for the clause is insurers’ fears that their involvement in the tort suit would result in higher or more frequent awards. *See JERRY, supra* note 17, § 84[b], at 548. A handful of jurisdictions, however, have statutes that permit direct actions. *See, e.g.,* WIS. STAT. ANN. § 632.24 (West 1995) (making the insurer directly liable for the amount of the policy to third parties injured by the insured).

The no-action clause, and the insurer concerns that motivate it, are only a partial explanation for this feature of the tort and liability insurance regime. If including the insurer in the tort suit would greatly reduce the costs associated with lingering coverage disputes—costs outlined *infra* text accompanying notes 150-164—one would expect to see pressure for change. For instance, courts might invalidate the no-action clause as against public policy. Or the marketplace itself could be expected to effect changes to the no-action clause if the costs of the no-action prohibition were sufficiently high.

On reflection, one can see that allowing a direct action would not be a simple cure for the knotty issues raised by lingering coverage disputes. Suppose the plaintiff sues both the

test for determining if a duty to defend exists at the outset, when the insurer first receives notice of a suit against the insured. The almost universally-used approach is the eight-corners rule: one takes the allegations in the plaintiff's complaint, assumes the truth of those allegations without resorting to evidence extrinsic to the complaint, and then asks whether these allegations, if true, would establish a liability covered under the policy.<sup>86</sup> Suppose, for instance, that the accident involves a boat that is insured under a policy containing a business purposes exclusion. If the plaintiff's pleading states that the boat was being used for recreational purposes, or if the pleading is ambiguous or silent on the recreational versus business use issue, in most jurisdictions the insurer will owe a defense under the eight-corners rule.<sup>87</sup> In addition, if only one of the claims contained in the lawsuit triggers the duty to defend, the insurer must provide a defense with respect to the

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insured and the insurer, and that coverage as well as liability is contested. If a single trial were to address both issues, then the insurer might be an adversary to the insured on an issue that is intertwined with the issues involved in the tort suit. This is the same problem that will be discussed below, *infra* text accompanying notes 114-115. One way to avoid this is to allow a direct action, but then to bifurcate the trial into coverage and liability issues. However, this raises many of the same problems, discussed later, presented by the separate adjudication of coverage and liability. See *infra* text accompanying notes 150-164.

86. See 1 WINDT, *supra* note 72, § 4.01, at 149-50 & n.11; see, e.g., *Lee v. Aetna Casualty & Sur. Co.*, 178 F.2d 750, 751-52 (2d Cir. 1949); *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991) (en banc); *George Muhlstock & Co. v. American Home Assurance Co.*, 502 N.Y.S.2d 174, 178-79 (App. Div. 1986).

87. Courts have traditionally resolved ambiguities in the pleadings in favor of finding a duty to defend. See JERRY, *supra* note 17, § 111[c][3], at 736; see, e.g., *Hecla Mining*, 811 P.2d at 1089 (stating that, if there is some doubt as to whether a covered theory has been alleged, the insurer owes a defense). But see, e.g., *National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc.*, 939 S.W.2d 139, 142 (Tex. 1997) (per curiam) (narrowing the degree of ambiguity that is sufficient to trigger the duty to defend, and holding that allegations must be sufficiently specific to "create that degree of doubt which compels resolution of the issue for the insured").

Most jurisdictions recognize a significant caveat to the complaint allegation rule. If the pleadings do not allege a potentially covered claim, but the insurer has knowledge of extrinsic facts that indicate a reasonable possibility of coverage, then the insurer has a duty to defend. See, e.g., *Fitzpatrick v. American Honda Motor Co.*, 575 N.E.2d 90, 93 (N.Y. 1991) (adopting the approach that the insurer must "provide a defense when it has actual knowledge of facts establishing a reasonable possibility of coverage"). Some courts, holding that the duty to defend exists when the insurer should have known the extrinsic facts, impose on insurers an obligation to investigate these facts. See *id.* at 93 n.2 (citing cases).

Courts and scholars generally agree that this exception to the complaint allegation rule promotes both efficiency and fairness. See ABRAHAM, *supra* note 27, at 201-03 (stating that only when an insurer finds it advantageous to defend will all resources be utilized); Fisher, *supra* note 8, at 146-49 (outlining the development of the duty to defend).



entire claim<sup>88</sup> because, in general, it is not possible to defend only the potentially covered claim.<sup>89</sup>

The second feature critical to the decisional structure of defense insurance is whether, even if the eight-corners rule governs at the outset, the insurer may adjudicate the duty to defend by means of extrinsic evidence in a declaratory judgment suit. Courts are currently split on whether and when this is possible. Most courts disallow the simultaneous adjudication of the duty to defend on the basis of extrinsic facts when those facts overlap with facts at issue in the tort suit.<sup>90</sup> A few courts, however, permit simultaneous adjudication.<sup>91</sup> In some jurisdictions, this issue remains unsettled or unaddressed.<sup>92</sup>

Both of these decisional features are easily explained and justified when an insurer's only reason for contesting a defense obligation is the substantive weakness of the underlying suit. For instance, suppose

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88. See 1 WINDT, *supra* note 72, § 4.12, at 199; *see, e.g.*, United States Fidelity & Guar. Co. v. Louis A. Roser Co., 585 F.2d 932, 936 (8th Cir. 1978) (providing an example of when a duty to defend all claims was triggered by a single claim); Horace Mann Ins. Co. v. Barbara B., 846 P.2d 792, 796 (Cal. 1993) (in bank) (same).

89. See 1 WINDT, *supra* note 72, § 4.13, at 203. If the defense of the uncovered claim can be separated, both conceptually and practically, from the defense of the covered claim, courts have allowed insurers to seek an allocation and to pay only the defense costs of the covered claim. *See id.* § 4.13, at 201-04; *see, e.g.*, SL Indus., Inc. v. American Motorists Ins. Co., 607 A.2d 1266, 1280 (N.J. 1992) (requiring the insurance company to pay only those defense costs associated with claims covered under the policy). Recent authority supports an insurer's right to seek reimbursement of defense costs that can be allocated entirely to the claims that the insurer never owed a duty to defend. *See, e.g.*, Buss v. Superior Court, 939 P.2d 766, 768-69 (Cal. 1997) (holding that an insurer may seek reimbursement for cost of defending claims not potentially covered under the policy).

90. *See, e.g.*, North E. Ins. Co. v. Northern Brokerage Co., 780 F. Supp. 318, 321 (D. Md. 1991) (providing an example of when separate adjudication is not permitted); Montrose Chem. Corp. v. Superior Court, 861 P.2d 1153, 1162 (Cal. 1993) (in bank) (discussing the problems of allowing separate adjudication and the need for a stay of the declaratory action). *See generally* 2 WINDT, *supra* note 72, § 8.04, at 8 (discussing the split in authority over whether to allow simultaneous adjudication of the duty to defend).

91. *See, e.g.*, State Farm Fire & Cas. Co. v. Mhoun, 31 F.3d 979, 983-84 (10th Cir. 1994) (permitting a separate declaratory judgment action); Metropolitan Property & Liab. Ins. Co. v. Kirkwood, 729 F.2d 61, 62-64 (1st Cir. 1984) (same); Group Ins. Co. v. Morelli, 314 N.W.2d 672, 674 (Mich. Ct. App. 1981) (same); Preferred Risk Ins. Co. v. Gill, 507 N.E.2d 1118, 1122-23 (Ohio 1987) (same); Reisen v. Aetna Life & Cas. Co., 302 S.E.2d 529, 533-34 (Va. 1983) (same).

92. *See, e.g.*, Farmers Texas County Mut. Ins. Co. v. Griffin, 955 S.W.2d 81, 84 (Tex. 1997) (per curiam) (ruling that the coverage issue can sometimes be adjudicated in a declaratory judgment action before the completion of the underlying tort suit, and suggesting but not deciding the guidelines for when this should be permitted). In Florida, the appellate courts are split. *Compare* Allstate Ins. Co. v. Conde, 595 So. 2d 1005, 1006 (Fla. Dist. Ct. App. 1992) (en banc) (allowing a declaratory judgment action to proceed in an overlapping case when the case involves alternative, mutually exclusive theories of liability, such as allegations of both intent and negligence) *with* Irvine v. Prudential Property & Cas. Ins. Co., 630 So. 2d 579, 580 (Fla. Dist. Ct. App. 1993) (expressly disagreeing with *Conde*).

an insurer wished to deny a defense because the statute of limitations had run on the theory of liability, or because the insured was not negligent. The standard policy language clearly ties the insurer's defense obligations to the claimant's allegations, not to the substantive merit of those allegations.<sup>93</sup> In addition, as noted in the previous subpart, insureds would wish to purchase, and insurers would be willing to sell, defense insurance that extended to suits lacking in substantive merit.<sup>94</sup> Thus, reliance on the complaint's allegations rather than the actual facts is an appropriate choice in this circumstance. Nor should the insurer be allowed to file a declaratory judgment suit seeking a ruling that the insurer owes no duty to defend because the underlying tort suit lacks merit.

It is harder to explain this decisional structure, however, when the insurer does not merely dispute the substantive strength of the plaintiff's claim, but wishes to deny a defense on the basis of actual (not alleged) facts that relate to *coverage*. To explore the decisional structure in such cases, it is important at the outset to note that denials on the basis of coverage fall into two categories. First, in overlapping scenarios, the insurer contests coverage on the basis of extrinsic facts that are also relevant to the underlying liability suit; that is, they may affect the strength or weakness of the insured's defense to the liability suit. Second, in nonoverlapping or coverage-only cases, the insurer disputes coverage on the basis of extrinsic facts that do not affect the merits of the underlying tort suit. For instance, whether a driver had permission of the named insured to drive the latter's car would not have any bearing on liability or damages in the tort suit and would relate only to coverage. But whether dumping occurred gradually could relate both to the merits of the tort case and to coverage. The remainder of this Part will discuss overlapping situations. Part III will discuss coverage-only situations.

#### A. *The Test at the Outset for Overlapping Cases*

In overlapping cases, should the complaint allegation rule govern the carrier's defense obligation at the outset, or should the carrier be allowed to deny a defense on the basis of the actual extrinsic facts relating to coverage?<sup>95</sup> As noted, the latter approach would match the

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93. See *supra* text accompanying notes 82-86.

94. See *supra* text accompanying notes 50-60.

95. In a recent article, Professor Randall argues that the actual facts should govern the duty to defend in all cases. See Randall, *supra* note 8, at 254-64. My analysis, developed independently of hers, reaches the same conclusion with respect to nonoverlapping cases, but takes a different view as to overlapping scenarios.

decisional structure that applies to other insurance promises.<sup>96</sup> The carrier promises that it will provide a benefit upon the happening of a covered condition; the carrier can deny that it is liable for the benefit. The carrier will be liable for that denial only if—in a suit by the insured against the carrier—the carrier loses on its noncoverage contention (the contention that the insured gave late notice, or that an exclusion applies).

An initial consideration is the language of the policy itself. Most courts interpret standard policy language to require use of the complaint allegation approach even when the insurer has a doubt about coverage.<sup>97</sup> Judge Learned Hand offered a classic exposition of this view:

This language means that the insurer will defend the suit, if the injured party states a claim, which, qua claim, is for an injury "covered" by the policy; it is the claim which determines the insurer's duty to defend; and it is irrelevant that the insurer may get information from the insured, or from any one else, which indicates, or even demonstrates, that the injury is not in fact "covered." The insurer has promised to relieve the insured of the burden of satisfying the tribunal where the suit is tried, that the claim as pleaded is "groundless."<sup>98</sup>

Yet the argument from policy language presents a problem. There is a tension between two strands of the standard policy language. On one hand, the language ties the defense obligation to what the plaintiff's claim *alleges*: the insurer will defend a suit "asking for these damages"; the insurer will defend the claim even if it is "groundless, false, or fraudulent."<sup>99</sup> On the other hand, the duty to defend seems linked to *coverage*: the insurer has no duty to defend any claim "not covered under this policy"; the insurer has a duty to defend a "claim . . . for damages because of 'bodily injury' or 'property damage' caused by an 'occurrence' to which this coverage applies."<sup>100</sup> These latter

96. See *supra* text accompanying notes 68-69.

97. See JERRY, *supra* note 17, § 111[c][2], at 735; see also *All-Star Ins. Corp. v. Steel Bar, Inc.*, 324 F. Supp. 160, 163 (N.D. Ind. 1971) ("Since the policy makes the duty to defend rest upon the allegations of the injured party, the Court has no authority to look beyond the allegations to the actual facts.").

98. *Lee v. Aetna Cas. & Sur. Co.*, 178 F.2d 750, 751-52 (2d Cir. 1949). The language in the policy stated that the insurer will "defend \* \* \* any suit against the Insured alleging injury . . . covered by this Policy \* \* \* even if such suit is groundless, false or fraudulent." *Id.* at 751 (star ellipsis in original).

99. See *supra* text accompanying notes 82-83 (quoting policy language).

100. See *supra* text accompanying notes 82-83.

phrases beg the central question: when, if at all, can the actual facts relating to coverage rather than the alleged facts be used to determine the duty to defend?

To supply a firmer basis for an answer, we might consider extrinsic evidence relating to these policy provisions, employ the doctrine of *contra proferentum*, or look to the reasonable expectations of the insured. I am unaware of extrinsic evidence that casts helpful light on the connection between the duty to defend and the actual facts relevant to coverage.<sup>101</sup> Nor are the principles of *contra proferentum* and reasonable expectations especially useful here. *Contra proferentum* instructs us, in cases of ambiguity, to select the reading that favors the insured, a directive that usually leads to the choice that gives the most coverage, *ex post*.<sup>102</sup> Yet our question at this juncture is to sketch the ideal contours of defense insurance, and thus the major concern should be what insureds, *ex ante*, would desire by way of such insurance.<sup>103</sup>

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101. One point worth noting in this respect is that the standard policy language relating to the duty to defend has not changed despite several major modifications of standard policies over the years. Nor, apparently, have insurers sought changes to this standard language of the defense obligation. See JERRY, *supra* note 17, § 111[a], at 729-32 (indicating that the language remains in current standard contracts). Yet most courts have been applying the eight-corners rule for many years. See *id.* § 111[c][1], at 734 (discussing the rule and listing cases). Thus, insurers' inaction could be seen as acquiescence to use of the eight-corners rule.

Yet this conclusion seems overdrawn. First, in a number of jurisdictions, courts have allowed departures from the eight-corners rule in limited instances of coverage-only facts. See *id.* § 111[c][2], at 736. Second, insurers have often been allowed to litigate the duty to defend by means of extrinsic evidence in a declaratory judgment proceeding when the evidence relates only to coverage. See *infra* notes 177-181 and accompanying text. Third, some jurisdictions permit the insurer to litigate the duty to defend by means of extrinsic overlapping evidence in a declaratory judgment proceeding. See *supra* note 91 and accompanying text. Thus, insurers' continued use of the standard duty to defend language does not necessarily indicate their acquiescence to an eight-corners rule that operates fully at the outset and throughout the litigation.

102. For discussion of *contra proferentum* in insurance law contexts, see KEETON & WIDISS, *supra* note 16, § 6.3(a)(2), at 629 (discussing the "thousands of judicial opinions" construing ambiguous policy language against the insurer); JEFFREY W. STEMPEL, INTERPRETATION OF INSURANCE CONTRACTS: LAW AND STRATEGY FOR INSURERS AND POLICYHOLDERS § 5.2, at 181-85 (1994); Kenneth S. Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996); James M. Fischer, *Why Are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995 (1992).

103. This is not an argument that achieving equity between insured and insurer in a given case is an irrelevant goal, or that equity in a given case should be sacrificed for considerations of efficiency in the long run. See generally ABRAHAM, *supra* note 27, at 10-18, 31-36 (discussing the systemic aims of insurance law, and specifically including economic efficiency and equity between the parties). My aim at this point is to determine which structure of defense insurance is optimal and fair from an *ex ante* perspective, not to answer an interpretive issue in a given case—a task for which the doctrine of *contra proferentum* seems more suited.

As to reasonable expectations,<sup>104</sup> neither of the interpretations arising from the actual policy language conflicts with concrete expectations that insureds have about the defense.<sup>105</sup> In addition, as Professor Kenneth Abraham has argued, the strong version of reasonable expectations is less an inquiry into insureds' concrete expectations than a method of achieving other goals, such as mandating appropriate levels of coverage or adequate information to the insured.<sup>106</sup> To the extent that these other goals are relevant to the question we are considering, they will be considered explicitly.

Presumably, defense insurance governed by the actual facts would be cheaper than defense insurance under the complaint allegation rule. The insured, then, would prefer an actual facts approach unless this would deliver inadequate coverage or pose real risks of decisional abuse. One might argue that an actual facts approach would necessarily offer inadequate defense coverage. Because the actual facts may be disputed until they are adjudicated, an actual facts standard means that we cannot know whether the insurer owed a duty to defend until the coverage issue is adjudicated. And the defense, to be meaningful, needs to be provided when the lawsuit is first filed. Courts often stress this point.<sup>107</sup>

Yet this same point is true of other types of insurance. The insured who files a disability claim needs the insurance payments for lost wages at that point, not later. If coverage is contested, however, the insured will not know whether coverage exists until the issue of disability or coverage is actually adjudicated. Yet disability insurers are not required to assume the truth of the insured's allegations. Rather, an insurer may, upon peril of liability if incorrect, deny a claim based on its assessment of how the coverage adjudication will turn out. Using an actual facts approach, therefore, does not mean that the insurer's duty attaches only once the actual facts are known. Instead, the duty

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104. The classic exposition of the doctrine appears in Robert E. Keeton, *Insurance Law Rights at Variance With Policy Provisions*, 83 HARV. L. REV. 961 (1970). For more recent analyses, see Kenneth S. Abraham, *Judge-Made Law and Judge-Made Insurance: Honoring the Reasonable Expectations of the Insured*, 67 VA. L. REV. 1151, 1168 (1981); Roger C. Henderson, *The Doctrine of Reasonable Expectations in Insurance Law after Two Decades*, 51 OHIO ST. L.J. 823, 826 (1990).

105. Probably the only concrete expectation that insureds have about the defense obligation is that the insurer owes a defense even if the lawsuit is a frivolous one.

106. ABRAHAM, *supra* note 27, at 110-12 (arguing that, in duty to defend cases, the doctrine of reasonable expectations has been employed to create the coverage that courts find desirable and sensible, not to protect concrete expectations of the insured).

107. See, e.g., *Montrose Chem. Corp. v. Superior Court*, 861 P.2d 1153, 1157 (Cal. 1993) (in bank) (stating that "[i]mposition of an immediate duty to defend is necessary to afford the insured what it is entitled to: the full protection of a defense on its behalf").

still attaches immediately if there is coverage, although the parties operate in the face of uncertainty about whether coverage exists.

There is, of course, a chance that the insurer will abuse its discretion in deciding whether to defend a case. Although abuses can and do occur, this does not explain why we would treat this decision—a decision about exclusions in litigation insurance—differently than noncoverage decisions in other settings, such as disability insurance, or homeowner's property protection. Concerns about decisional abuse and the special injuries it poses to vulnerable insureds have spawned a whole battery of extracontractual protections in the form of statutes,<sup>108</sup> regulations,<sup>109</sup> and common law bad faith protections.<sup>110</sup> To the extent necessary, the same protections could be applied (and are in many jurisdictions) to decisions about the defense obligation.<sup>111</sup> For example, if the carrier was ultimately wrong in its position that an accident stemmed from the noncovered business activities of the insured, then the carrier would pay contractual and extracontractual damages. Indeed, the carrier arguably has greater incentive to make the right call on the duty to defend than on other insurance promises. The insurer that denies a defense loses the right to control the defense and settlement, and in some jurisdictions may lose its coverage defense if the denial is wrongful.<sup>112</sup>

There is, however, reason to treat defense insurance differently. The insured who is wrongfully denied a defense in an overlapping

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108. See, e.g., TEX. INS. CODE ANN. art. 21.21-2, § 2(b)(4) (West Supp. 1998) (enumerating as an unfair settlement practice, inter alia, "[n]ot attempting in good faith to effectuate prompt, fair, and equitable settlements of claims submitted in which liability has become reasonably clear").

109. See, e.g., ARIZ. ADMIN. CODE R20-5-163 (1968) (defining "bad faith" and "unfair claim processing practices" and granting the Industrial Commission authority to award damages to victims of such practices).

110. See ABRAHAM, *supra* note 27, at 173-206 (discussing history and rationales for extracontractual regulation of the claims process); JERRY, *supra* note 17, § 25[G] (discussing history and current doctrinal boundaries of bad faith law); Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions: Refining the Standard of Culpability and Reformulating the Remedies by Statute*, 26 U. MICH. J.L. REFORM 1, 4 (1992) (discussing "the common-law and statutory background of the tort of bad faith in first-party insurance situations, analyz[ing] the varying standards of culpability . . . [,] and suggest[ing] a uniform statutory solution to the problems created by the[se] varying standards"); *Symposium on the Law of Bad Faith in Contract and Insurance*, 72 TEX. L. REV. 1203 (1994) (discussing theory and doctrine of bad faith in insurance and contract).

111. See LITIGATING THE COVERAGE CLAIM, *supra* note 8, at 119 (discussing the consequences of a wrongful refusal to defend); Karon O. Bowdre, "Litigation Insurance": *Consequences of an Insurance Company's Wrongful Refusal to Defend*, 44 DRAKE L. REV. 743, 761-66 (1996) (discussing contractual and tort remedies for a breach of the duty to defend).

112. See Bowdre, *supra* note 111, at 757-59 (setting forth various consequences to the insurer of an erroneous decision not to defend).

scenario might be handicapped in pursuing the remedies that in theory are available to her. Suppose that the insured has been sued for pollution, and the case against her is pending. Her carrier has denied a defense, and she has had to cope with this as best she can—for example, by hiring a lawyer on her own. If she wishes to pursue the insurance company, she must file another lawsuit, while the pollution suit against her is pending.<sup>113</sup>

Yet the facts and theories at issue in the coverage suit will overlap with facts and theories at issue in the underlying tort suit. Such overlapping issues could include whether the insured dumped pollutants onto her neighbor's land; for how long she did so; how much and exactly when; and whether the insured caused the harm intentionally. Under an actual facts approach—as distinct from the complaint allegation approach—the insurer would be allowed, in the suit over the duty to defend, to bring its considerable resources and expertise to bear on exploring these factual issues. This could harm the insured in the underlying suit in several ways. It could generate evidence that would harm the insured in the underlying case. It could result in a finding on the intentional harm issue that would be given collateral estoppel effect in the tort suit (if the tort plaintiff were joined as co-defendant in the declaratory judgment proceeding).<sup>114</sup> It could stra-

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113. Another option for the insured is to settle the case. If the insured believes she is not liable, however, or if the insured and plaintiff disagree over the proper settlement amount, the insured should not be forced into settling just because she is unable to muster a defense. Another settlement variation is the following: plaintiff and insured settle the case and enter an agreed judgment; plaintiff executes a covenant not to execute against the insured for this sum; and in exchange for the covenant the insured assigns to the plaintiff her contractual and extracontractual rights against the carrier.

Although this route is often taken, it cannot be viewed as a general solution to wrongful denials of the defense obligation. These arrangements have rightly raised concerns about the potential for structural collusion. As a result, some jurisdictions arguably disallow them, and other jurisdictions police them heavily. See, e.g., *State Farm Fire & Cas. Co. v. Gandy*, 925 S.W.2d 696, 713-15 (Tex. 1996) (invalidating the use of pre-trial assignments in some cases, although leaving open the permissibility of these arrangements in situations when the insurer refuses a defense). See generally Chris Wood, Note, *Assignments of Rights and Covenants Not to Execute in Insurance Litigation*, 75 TEX. L. REV. 1373, 1377, 1410 (1997) (discussing various approaches to the competing concerns raised by assignment-covenant arrangements and “suggest[ing] a set of rules by which a desirable balance between the interests of insureds and carriers may be achieved”).

114. See JERRY, *supra* note 17, § 114[c][4], at 800 (“[T]he holding in the declaratory judgment [coverage] action might collaterally estop the parties in the underlying action on certain fact questions.”). Most courts will allow or require the tort plaintiff to be joined as a co-defendant in the declaratory judgment action if that action will adjudicate coverage. See, e.g., *Constitution Assoc. v. New Hampshire Ins. Co.*, 930 P.2d 556, 562 (Colo. 1996) (concluding that “an allegedly injured party in the underlying action[] may defend an anticipatory declaratory judgment as long as the action is properly initiated by a party with a legally cognizable claim”); cf. *Home Ins. Co. v. Gephart*, 639 So. 2d 179, 180 (Fla. Dist. Ct.

telegically undermine the insured's defensive posture in the tort case. For instance, the insured's best defense to the coverage issue might be to argue that the insured was, at most, negligent. Presenting this argument, however, could undermine the insured's effort, in the tort case, to show that he was not negligent at all.<sup>115</sup>

This insured, then, is both like and unlike insureds under other types of policies. Like other insureds, she has been denied a benefit at a time when it has great importance to her; she must pursue her contract and tort remedies to receive what she is owed, if the insurer is wrong. But, unlike other insureds, the very pursuit of these remedies may pose the distinct and considerable burden of disadvantaging her defense of the ongoing tort litigation.

There is no satisfactory way of eliminating this burden. It is of little comfort to the insured to tell her that she could wait until the end of the tort litigation to pursue her claims against the carrier. Nor is there a way to build a solid wall between the duty-to-defend lawsuit and the plaintiff's lawsuit against the insured. Finally, it is not possible to shape the actual facts approach in a way that would avoid these problems in all cases.<sup>116</sup>

These concerns make a solid case for retaining the complaint allegation approach when the insurer's coverage argument depends on extrinsic facts that overlap with the liability case. Insurers, to be sure, might still improperly deny a defense even under a complaint allegation approach. But the insured could pursue the insurer without triggering the need for factual inquiry into and adjudication of the very facts that also are at stake in the tort suit.

### *B. Use of Extrinsic Evidence in a Declaratory Judgment Proceeding*

Even if the complaint allegation rule governs at the outset, a further question is whether the insurer should be permitted to adjudicate the duty to defend via extrinsic evidence in a declaratory judgment proceeding before the completion of the underlying tort suit. This would be tantamount to allowing the insurer to adjudicate the coverage issue in a simultaneous declaratory judgment action. For

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App. 1994) (per curiam) (affirming dismissal of insurer's declaratory judgment action, in part because the plaintiff from the underlying suit had not been joined as a party to the proceedings).

115. For discussion of this problem, see *Hartford Insurance Group v. District Court*, 625 P.2d 1013, 1016 (Colo. 1981) (en banc); *State Farm Fire & Casualty Co. v. Finney*, 770 P.2d 460, 461, 466 (Kan. 1989).

116. Even if the findings in the coverage suit were not given collateral estoppel effect with respect to the tort suit, other spillover effects could occur. See *supra* text accompanying notes 114-115.



instance, if the insurer were allowed to adjudicate the intentional harm issue in the declaratory judgment action, a ruling favorable to the insurer would resolve not just the duty to defend, but also the duty to indemnify. As noted before, although most courts disallow the adjudication of the duty to defend via extrinsic evidence in an overlapping case, others permit it, and the issue remains unsettled in some jurisdictions.<sup>117</sup> Analysts also are in disagreement over the proper approach.<sup>118</sup>

Addressing this issue implicates two related but distinct bodies of law: insurance law, and the law relating to declaratory judgments. Of course, whether courts should exercise their discretion to allow declaratory judgment proceedings in this or any other context is ultimately governed by the federal declaratory judgment act<sup>119</sup> or the

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117. See *supra* notes 90-92 and accompanying text.

118. See 2 WINDT, *supra* note 72, § 8.04, at 8 (noting that the majority of cases "have held that a declaratory judgment should not be entered if it depends on the resolution of factual disputes that are at issue in the underlying action"); Davis J. Howard, *Declaratory Judgment Coverage Actions: A Multistate Survey and Analysis and State Versus Federal Law Comparison*, 21 OHIO N.U. L. REV. 13, 26 (1994) ("Treatises, rather than cases, have dealt in greater depth with this issue, the consensus being that [declaratory judgment actions] should be dismissed or stayed in the presence of factual intermixture that may prejudice the insured . . ."). But see Alan M. Posner, *Prematurity of Declaratory Judgment Actions: Does State or Federal Law Apply?*, BRIEF, Fall 1995, at 15, 40 (arguing that adjudication of the coverage issue, even in overlapping contexts, can permit a more prompt resolution of the disputed issues and can prevent a "negligence" claim from being used as a device to obtain coverage for blatantly purposeful acts); Gregor J. Schwinghammer, Jr., Comment, *Insurance Litigation in Florida: Declaratory Judgments and the Duty to Defend*, 50 U. MIAMI L. REV. 945, 978-79 (1996) (proposing that insurers be allowed to seek declaratory judgments even when the coverage issue overlaps with the tort suit, so long as the insured is not bound by findings in the coverage suit).

119. 28 U.S.C. § 2201(a) (1994). For a recent discussion of the Federal Declaratory Judgment Act in the context of insurance, see *Wilton v. Seven Falls Co.*, 515 U.S. 277 (1995). In *Wilton*, the Court rejected the insurer's argument that a district court with jurisdiction over the declaratory judgment proceeding should not stay or dismiss that proceeding unless "exceptional circumstances" exist. *Id.* at 287-88. The Court held that district courts have substantial latitude to dismiss or stay a declaratory judgment action, even when the action satisfies the requirements of subject matter jurisdiction. See *id.* at 289-90 (relying on *Brillhart v. Excess Ins. Co. of Am.*, 316 U.S. 491 (1942)). According to the *Wilton* Court, *Brillhart* counsels against allowing the declaratory judgment action to proceed "at least where another suit involving the same parties and presenting opportunity for ventilation of the same state law issues is pending in state court." *Id.* at 283. *Wilton*, however, does not try to delineate the complete boundaries relating to the use of declaratory judgments in insurance contexts. See *id.* at 290.

The *Wilton* opinion does not settle the fate of declaratory judgment actions of the type discussed in this Article. In *Wilton*, the insurer had denied a duty to defend, and the underlying tort suit had proceeded to judgment; the insurer then filed a federal declaratory judgment action to resolve the coverage issue, and the insured filed a coverage suit in state court. See *id.* at 279-80. Thus, the state and federal actions were essentially parallel proceedings. See *id.* at 283 (citing *Brillhart* for authority to stay a federal declaratory judgment

state declaratory judgment statute<sup>120</sup> under which the insurer seeks to proceed. Yet, in deciding whether to allow the declaratory judgment action under state or federal laws, courts apply a number of guidelines, such as whether the action would help to clarify legal relations, whether it would amount to duplicative or piecemeal litigation, or whether it would be superior to other alternatives.<sup>121</sup> In applying many of these guidelines to the extrinsic evidence question, insurance considerations are crucial.<sup>122</sup> For instance, whether the declaratory

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action when a state suit involving the same parties and the same issues is pending). By contrast, when an insurer files a declaratory judgment relating to the duty to defend and to coverage when the state suit is still pending, the state suit does not represent a parallel proceeding. The insurer cannot be a party to the tort suit in most jurisdictions, and the tort suit generally will not adjudicate coverage issues. See *supra* note 85.

120. Over forty states have adopted some or all of the Uniform Declaratory Judgment Act. See Dianne K. Ericsson, *Declaratory Judgment: Is It a Real or Illusory Solution?*, 23 TORT & INS. L.J. 161, 162 (1987). Under section 6 of the Uniform Act, "The court may refuse to render or enter a declaratory judgment or decree where such judgment or decree, if rendered or entered, would not terminate the uncertainty or controversy giving rise to the proceeding." UNIF. DECLARATORY JUDGMENT ACT § 6, 12A U.L.A. (West 1996).

121. See *Wilton*, 515 U.S. at 288 ("In the declaratory judgment context, the normal principle that federal courts should adjudicate claims within their jurisdiction yields to considerations of practicality and wise judicial administration."); *Nationwide Ins. v. Zavalis*, 52 F.3d 689, 691-92 (7th Cir. 1995) (suggesting matters which the federal court should consider when deciding whether or not to refuse a declaration); *State Farm Fire & Cas. Co. v. Mhoon*, 31 F.3d 979, 982-83 (10th Cir. 1994) (approving the list of factors that the Sixth Circuit considers when deciding whether or not to hear a declaratory action); *Terra Nova Ins. Co. v. 900 Bar, Inc.*, 887 F.2d 1213, 1224-25 (3d Cir. 1989) (noting the general guidelines of the Third Circuit for the exercise of discretion under the Declaratory Judgment Act); 10A C. WRIGHT ET AL., *FEDERAL PRACTICE AND PROCEDURE* §§ 2759-2760 (1998) (discussing standards under the Federal Act); see also *Constitution Assoc. v. New Hampshire Ins. Co.*, 930 P.2d 556, 560-61 (Colo. 1996) (noting that, among the requirements of the Colorado statute, courts should not render a declaratory judgment unless it will fully and finally resolve uncertainty and controversy between all parties with a substantial interest).

For discussion of declaratory judgment actions in insurance settings, see Raphael Cotkin & Philip S. Guitierrez, *Walking the Tightrope: Contesting Coverage During the Underlying Case, in LITIGATING THE COVERAGE CLAIM: DENIAL OF COVERAGE & DUTY TO DEFEND* 145, 147 (A.B.A., Tort & Insurance Practice Section, 1992); Ericsson, *supra* note 120, at 162; Howard, *supra* note 118, at 13; Posner, *supra* note 118, at 15; Schwinghammer, *supra* note 118, at 946.

122. See, e.g., *Terra Nova*, 887 F.2d at 1225 (noting that, in exercising discretion under the federal act, courts properly include some considerations that are more insurance-specific); *Metropolitan Property & Liab. Ins. Co. v. Kirkwood*, 729 F.2d 61, 62 (1st Cir. 1984) (stating that the caselaw under the federal statute "give[s] these general principles a somewhat more specific meaning in the context of insurance disputes").

One oft-cited case, *Allstate Insurance Co. v. Harris*, 445 F. Supp. 847 (N.D. Cal. 1978), illustrates how judicial discretion considers insurance issues in applying the Federal Declaratory Judgment Act. After considering issues of federal-state comity, the court noted that resolving the issue of the insured's intent "in a separate federal court proceeding when a similar issue involving the same evidence and essentially the same parties is pending in state court . . . causes this Court grave concern." *Id.* at 850. The court noted, however, that because the tort suit would not resolve the coverage issue, dismissing the declaratory judg-

judgment action would "serve a useful purpose in clarifying the legal obligations and relationships among the parties"<sup>123</sup> depends in part on whether the use of extrinsic evidence in the declaratory judgment would be consistent with the insurance policy, or whether it would undermine the insured's reasonable expectations under the policy.<sup>124</sup>

Other guidelines concerning declaratory judgment actions seem less related to insurance, and instead stem from considerations of federal-state comity or interference with adjudication in the underlying lawsuit. For example, some federal courts have disallowed a declaratory judgment when it would adjudicate an unsettled issue of state insurance law.<sup>125</sup> This choice is based on considerations of federal interference with the state adjudicative process, not considerations of justice or efficiency in the tort liability insurance regime.

The following discussion explores the considerations that should be most important in deciding whether to allow the declaratory judgment option in overlapping cases. One caveat is necessary, however. The discussion does not fully address considerations relating solely to the relationship between federal and state courts. Rather, the main question is the desirable boundaries of the duty to defend in light of the goals of the tort liability regime, justice and efficiency. Once this question is examined, considerations that relate solely to federal-state relations (such as not tackling unsettled issues of state law) can be added to the analysis.

*1. The Disadvantages of the Declaratory Judgment Option for Overlapping Cases.*—In overlapping scenarios, allowing adjudication of the

ment action would only serve to force the parties to start a separate coverage suit in state court. *See id.* at 851. Thus, the court indicated that, if it considered solely the issues of efficiency and comity, it should permit the declaratory judgment. *See id.* Nonetheless, the court stayed the declaratory judgment pending the outcome of the state tort action because "a trial at this point in the proceedings would place an unfair burden on the insured, in violation of his expectations and of the policies favoring insurance against risks." *Id.*

123. *Zavalis*, 52 F.3d at 692.

124. *See, e.g., Harris*, 445 F. Supp. at 851 (noting that the use of a declaratory judgment in this instance would defeat the reasonable expectations of the insured, and explaining why this consideration is relevant to the exercise of discretion under the Federal Declaratory Judgment Act).

125. *See, e.g., North E. Ins. Co. v. Northern Brokerage Co.*, 780 F. Supp. 318, 322 (D. Md. 1991) (noting that the question of which events trigger coverage implicates an important issue of public policy and thus should be resolved by a state court); *Zurich Ins. Co. v. Alvarez*, 669 F. Supp. 307, 311 (C.D. Cal. 1987) (noting that the declaratory judgment action "raises numerous difficult and complex ancillary issues of first impression under state law which are better left for decision by state tribunals"); *State Farm Fire & Cas. Co. v. Poomaihealani*, 667 F. Supp. 705, 707 (D. Haw. 1987) (agreeing that the declaratory judgment should be stayed because, among other reasons, the federal courts "lack any significant federal interest in deciding the state law issues which predominate in this case").

duty to defend by means of extrinsic evidence in a declaratory judgment proceeding presents several potential problems that bear examination. These problems fall under three categories: potential harm to the insured; interference with the underlying tort proceeding; and efficiency in the adjudicative process.

*a. Potential Harm to the Insured.*—Courts that reject the declaratory judgment option often cite concerns about harm to the insured, ranging from the inconvenience and expense of defending an additional lawsuit<sup>126</sup> to the substantive disadvantage that the simultaneous suit might pose for the insured in the underlying suit.<sup>127</sup> The possible harm to the insured should be evaluated in light of efficient loss-spreading and fairness as between insurer and insured.<sup>128</sup>

The key question with respect to efficient loss-spreading is whether the informed insured, *ex ante*, would purchase defense insurance under which the insurer would be allowed to contest the duty to defend by means of extrinsic evidence in a simultaneous declaratory judgment action. This question bears on efficient loss-spreading because, if informed insureds (or some category thereof) would prefer to purchase such defense insurance, then this form of defense insurance represents the optimal level for at least some insureds.<sup>129</sup> This *ex ante* inquiry is different from asking whether the insured, once faced with a lawsuit, would prefer the more protective form of defense insurance; of course he would. The more appropriate focus, however, is the content and scope of the defense insurance that the insured would purchase in an actuarially fair insurance market.

We can plausibly presume that insureds would be charged higher premiums for litigation insurance governed fully by the complaint allegation rule, and would pay lower premiums for defense insurance that allowed adjudication of the duty to defend by means of extrinsic evidence. This is because, under the latter approach, insurers would more often be able to escape the duty to defend on the basis of extrinsic facts. Because potential defense costs would decline, the actuarially fair premium of such insurance also should decline.

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126. See, e.g., *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1090 n.11 (Colo. 1991) (en banc); *Irvine v. Prudential Property & Cas. Ins. Co.*, 630 So. 2d 579, 580 (Fla. Dist. Ct. App. 1993); *Morris v. Farmers Ins. Exch.*, 771 P.2d 1206, 1211 (Wyo. 1989).

127. See, e.g., *Harris*, 445 F. Supp. at 850.

128. See *supra* notes 80-81 and accompanying text.

129. Cf. SHAVELL, *supra* note 2, at 228-45 (discussing which levels of liability awards comport with optimal loss-spreading); Priest, *supra* note 3, at 1556 (arguing that it would hurt consumer interests to force individuals to purchase insurance more extensive than the informed individual would wish).

Even though such insurance should be cheaper, there is a serious question whether, *ex ante*, insureds would prefer it. Allowing the simultaneous litigation of overlapping extrinsic evidence presents two possible problems for the insured. The first is that the insurer becomes an adversary on an issue that relates to the tort suit. A second problem is not so much *the fact* that the insurer can become an adversary, but the *timing* of this relationship: The insurer is adverse to the insured at the same time the tort suit is going on.<sup>130</sup>

The latter problem is the troublesome one. In any insurance relationship, the possibility exists that the insurer and insured will become adversaries on a coverage issue. So this possibility, by itself, is not a strong reason to disallow the declaratory judgment.<sup>131</sup> Yet, this possibility, if it occurs while the tort suit is pending, is troublesome for several reasons. First, as explained earlier,<sup>132</sup> litigating the coverage question while the tort suit is still pending could undermine the insured's defense in the tort suit. For instance, in a suit involving allegations of negligence and intentional harm, the declaratory judgment action could: result in a finding on the intentional harm issue that would be given effect in the tort suit; generate proof that could be used against the insured in the underlying tort suit; and strategically undermine the insured's defensive posture in the tort case.

In other overlapping cases, this potential for undermining the insured's defense in the tort suit seems unlikely. For instance, suppose that the defendant is sued on a tort theory by an employee for an injury that arguably did not occur in the course and scope of employment. The defendant employer's general liability insurer might provide a defense and then try to establish in the declaratory judgment

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130. See *supra* notes 114-115 and accompanying text (discussing the problem of litigating overlapping factual issues in the declaratory judgment action).

131. Consider what would happen if the insurer were not allowed to litigate a coverage issue in a declaratory judgment action—for example, whether the insured intentionally caused the harm. Then the tort suit would proceed, and the insurer would have to provide a defense. Suppose the tort suit results in a finding that the injury was inflicted negligently and that it was not intentional. Given the conflict of interest between the carrier and the insured on the intentional harm issue, the tort suit's finding on this issue would not have collateral estoppel effect if the insurer relinquished control of the defense in the face of this conflict of interest. See 1 WINDT, *supra* note 72, § 6.22, at 430-31. Thus, in the coverage suit following the tort suit, the insurer could be a full and formidable opponent to the insured on the intentional harm issue.

Hence, dismissing the declaratory judgment action does not eliminate the prospect that the insurer will become the insured's adversary on an issue that is also central to the tort suit. The dismissal only postpones this prospect. The mere *fact* of insurer as adversary, then, does not seem reason to disallow the use of the extrinsic evidence in the declaratory judgment suit.

132. See *infra* text accompanying notes 114-115.

action that the injury occurred within the course and scope of employment (and thus fell outside the general liability policy, and under the coverage provided by the worker's compensation insurer).<sup>133</sup> The employee plaintiff, however, would not be trying to establish the same point in the tort suit. Instead, the plaintiff would argue that the injury occurred outside the course and scope of employment, because without this finding the plaintiff would be restricted to workers' compensation benefits. Thus, the insurer would not be substantively aligned with the plaintiff against the insured on an issue in the tort suit.<sup>134</sup> The most troublesome cases, then, are those in which the insurer's position in the coverage suit might in some way undermine the strength of the insured's defense as to liability or damages.

The simultaneous timing of declaratory judgment actions presents a second problem: saddling the insured with sizable litigation costs at the very time when the insured expected to be relieved of such costs. To evaluate the seriousness of this concern, we can draw a rough but useful distinction between individual insureds, who realistically will not be able to bear additional litigation costs, and corporate insureds, a category that includes corporations or individuals with assets sufficient to finance litigation.

Consider the simultaneous litigation scenario involving an individual insured. Recall, too, that we are evaluating a set of rules that requires the insurer to provide a defense—based on the complaint allegation rule—yet that allows the insurer to file a declaratory judgment action and try to escape the duty to defend on the basis of the extrinsic facts adjudicated in that action. Thus, by hypothesis, the insured is being provided counsel—probably independent counsel—in the underlying tort suit.<sup>135</sup> Given this hypothesis, simultaneous litiga-

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133. See ALLIANCE OF AMERICAN INSURERS, *supra* note 9, at 199 (reprinting commercial general liability policy containing an exclusion for bodily injury to an employee arising out of the course of employment by the insured).

134. For an overlapping fact case in which the overlapping facts were not contested, see *Hagen v. Aetna Casualty & Surety Co.*, 675 So. 2d 963, 964-65 (Fla. Dist. Ct. App. 1996) (en banc). In *Hagen*, a commercial general liability policy excluded coverage for injuries arising out of the operation or use of any automobile by the insured. See *id.* at 965. The injury occurred when workers were unloading carpet from one truck by tying one end of a rope to the roll of carpet and the other end to the bumper of another truck, which then pulled forward and thus pulled the carpet forward. See *id.* at 964. This could be seen as an overlapping fact case because some of the facts relating to coverage—for example, the employees' use of the truck to pull the carpet—also relate to the merits of the liability case. When overlapping facts are not contested, the declaratory judgment should be allowed.

135. When a conflict of interest exists between the interests of the carrier and the insured defendant, jurisdictions differ about the carrier's defense obligation. The predominant modern approach is that the carrier must pay for independent counsel when a conflict of interests exists that would affect the way in which the defense is conducted. See

tion might appear to pose a problem no different from that inherent in any other insurance relationship: the need for the insured to incur the costs of litigation against the insurer in a contested coverage action. This is a problem that remedial schemes such as fee-shifting or extracontractual liability in theory can address.

On inspection, however, the litigation costs of the simultaneous declaratory judgment action pose a different problem. As noted, at times the insurer in the declaratory judgment action will be taking a position that aligns with or that assists the tort plaintiff's position in the underlying litigation.<sup>136</sup> If litigation costs prevent the insured from mustering any defense or an adequate defense to the declaratory judgment, this will affect more than the insured's chances in the coverage dispute. It could also harm the insured in the tort suit. As noted before, some harmful spillover is possible whenever the insurer's position in the declaratory judgment action aligns with or assists the tort plaintiff's position in the underlying case.<sup>137</sup> This potential for spillover becomes even more troublesome when we realize that lack of funds will prevent some individual insureds from mounting an adequate defense to the declaratory judgment action.

By contrast, corporate insureds presumably would be able to mount an adequate defense in the declaratory judgment action. Thus, for such insureds, the need to incur litigation costs to fight the declaratory judgment action would be functionally similar to the problem that inheres in any insurance relationship: the possibility that the insured will not obtain the promised contractual benefits without first incurring litigation costs. Although this problem is not insignificant, it is not unique to the third-party coverage context, and presumably could be addressed as the problem is in other contexts.<sup>138</sup>

In sum, simultaneous declaratory judgment actions relating to overlapping facts are not troublesome solely because the insured is an adversary to the insurer on a coverage question. This potential exists in all insurance contexts. Rather, the timing is troublesome. First, for all insureds—individual and corporate—there is potential for spillover whenever the insurer's position in the declaratory judgment action undermines the defendant's defense in the underlying lawsuit. Second, for individual insureds, this spillover concern is exacerbated

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1 WINDT, *supra* note 72, §§ 4.20-4.22 (discussing this approach); Barker, *When Does the Insurer Lose*, *supra* note 8, at 470-79 (providing a thorough analysis of how a conflict of interest relates to the insurer's defense obligation).

136. See *supra* text accompanying notes 114-115.

137. See *supra* text accompanying notes 114-115.

138. See *supra* notes 108-112 and accompanying text.

because a lack of assets might prevent such insureds from presenting an adequate defense in the declaratory judgment proceeding.

Allowing declaratory judgment actions in all overlapping cases, then, would not be an attractive approach to insureds *ex ante*. For individual insureds, the security afforded by defense insurance would have a substantial gap: in some cases, the individual will face an additional lawsuit that is filed by the insurer and that poses the risk of undermining or weakening the insured's position in the tort suit. This problem is less significant for corporate insureds that can be confident of mounting an adequate defense to the declaratory judgment proceeding. Even these insureds, however, might be willing to pay a higher premium to avoid the chance that the declaratory judgment proceeding will weaken or undermine the insured's substantive chances in the tort lawsuit.<sup>139</sup>

2. *Efficiency in the Adjudicative Process.*—One could also argue that the declaratory judgment option would be an inefficient use of judicial resources for two reasons. One variation of the argument is that deciding the coverage issue before the completion of the tort suit is less efficient than deferring the coverage issue until after completion of the tort suit.<sup>140</sup> As one court explained, "Since there is a possibility that the tort claim may be proven invalid in state court, there is no need to litigate in advance the issue of who should pay for the tort claim if it proves to be valid."<sup>141</sup> The point has a surface appeal, but contains gaps. First, the argument at most asserts that coverage does not need to be adjudicated, for purposes of the duty to indemnify, before the completion of the tort suit. It tells us nothing about

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139. These points about potential harm to the insured's defense also bear on another aim of insurance law besides efficiency and risk distribution, namely, achieving fairness between insurers and insureds. See ABRAHAM, *supra* note 27, at 31-32. Thus, our inquiry must focus not only on whether a fully informed individual would purchase such defense insurance, but also whether insureds under current policies can be said to have made informed decisions to purchase such insurance. See *id.* at 31-33 (considering the issue of equity between insurers and insureds by discussing, among other things, the "[i]nformation [i]mbalance" and the "[d]isparity of [b]argaining [p]ower"); see also *Allstate Ins. Co. v. Harris*, 445 F. Supp. 847, 851 (N.D. Cal. 1978) (stating that "the insured could not possibly have anticipated that the very resources for which he bargained would be turned against him and used to establish his liability").

140. See, e.g., *Morris v. Farmers Ins. Exch.*, 771 P.2d 1206, 1212 (Wyo. 1989) (stating that the "[b]enefit in duplicate litigation is not discernable when the liability of the insurer remains contingent and may never materialize for indemnity payment").

141. *Zurich Ins. Co. v. Alvarez*, 669 F. Supp. 307, 310 (C.D. Cal. 1987). For a case framing the same point in terms of justiciability, see *Prashker v. United States Guarantee Co.*, 136 N.E.2d 871, 874-75 (N.Y. 1956) ("The courts do not make mere hypothetical adjudications, where there is no presently justiciable controversy before the court . . .").



whether adjudication of coverage would be sensible or efficient as to the duty to defend. Second, even though ultimately the tort suit might result in a finding of no liability, leaving the coverage issue unresolved has other undesirable effects relating to efficiency in the adjudicative process. These effects are explored in the next section.<sup>142</sup> At a minimum, these other effects should be considered before one reaches a conclusion about the efficiency of the declaratory judgment option.

A second possible version of the inefficiency argument is that allowing the declaratory judgment in an overlapping fact case will often result in two full-blown adjudications of the same or very similar issues. Sometimes this duplication will not occur. The coverage and liability issues might be factually linked but largely dissimilar. Or, even if the issues are the same, the declaratory judgment action might be completed before the same issue is aired in the tort suit; the finding in the declaratory judgment action thus could be given collateral estoppel effect in the tort suit (if the tort plaintiff were made a party to the declaratory judgment action).<sup>143</sup> Nonetheless, in at least some cases, both the declaratory judgment action and the tort action will engage in factfinding relating to the same or a closely similar issue. For instance, both might adjudicate whether the defendant intentionally caused the harm.<sup>144</sup>

On inspection, however, the criticism relating to duplication misses the mark. Disallowing the declaratory judgment action often will not avoid the need for seemingly duplicative factfinding. The intent-negligence scenario illustrates this point. Suppose that the declaratory judgment action is dismissed or stayed, that the tort suit adjudicates the issue of whether the insured caused the harm intentionally, and that the defendant is found liable for negligently caused harm. In many jurisdictions, if the insurer has provided a defense, it has to pay for independent counsel because the overlap between the liability and coverage issues creates a conflict of interest over the conduct of the defense in the underlying suit.<sup>145</sup> So, even if

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142. See *infra* Part II.B.4 (discussing undesirable effects such as structural collusion, insurance funds being paid for uninsurable harms, collateral disputes, and an increase in the number of tort suits that are tried rather than settled).

143. See *supra* note 114.

144. See, e.g., *Harris*, 445 F. Supp. at 850 (explaining that both actions would adjudicate whether the defendant intentionally caused the harm).

145. 1 WINDT, *supra* note 72, § 4.20, at 218-19 (stating that if there is a conflict of interest with respect to the manner in which the lawsuit should be defended, "the insurer should consider either hiring 'independent counsel' to represent the insured or allowing the insured to select private counsel"); Barker, *When Does the Insurer Lose*, *supra* note 8, at 470

the jury renders a finding on the overlapping issue—in this case, that the defendant did not act intentionally—that finding will not be given collateral estoppel effect with respect to the coverage question between insurer and insured. Rather, the issue will have to be litigated again in a coverage suit.<sup>146</sup> Thus, disallowing the declaratory judgment does not necessarily eliminate the prospect of two adjudications relating to the same factual issue.

3. *Interference With the Underlying Tort Proceeding.*—Another possible problem with the declaratory judgment option is interference with the underlying tort proceeding. Courts often cite this as a concern.<sup>147</sup> To an extent, this concern might be another way of stating the same problems as those just discussed—potential harm to the insured, or inefficient duplication of factfinding. When voiced by federal courts, the interference concern often relates to deciding issues of state insurance law.<sup>148</sup> In addition to these issues, the concern over interference might indicate an independent interest in allowing the tort proceeding to adjudicate the issues relevant to that proceeding, apart from any possible harm to the insured. Perhaps a part of this concern is the notion that the tort plaintiff is entitled to resolution in the tort forum of all the issues relevant to the tort case.<sup>149</sup>

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(“The insurer’s role is limited to payment of counsel who represents and is directed by the insured alone.”).

146. For a discussion of these points, see *State Farm Fire & Casualty Co. v. Mhoon*, 31 F.3d 979, 983-84 (10th Cir. 1994).

147. See, e.g., *Irvine v. Prudential Property & Cas. Ins. Co.*, 630 So. 2d 579, 580 n.1 (Fla. Dist. Ct. App. 1993) (criticizing the declaratory judgment option as allowing “the trial of the entire [tort] case” to be “moved into the declaratory judgment action, but with the insureds having to pay their own attorney’s fees”); *State Farm Fire & Cas. Co. v. Finney*, 770 P.2d 460, 464 (Kan. 1989) (noting that cases have disallowed the declaratory judgment when it would predetermine “at least one very cogent issue of the tort action[ ], since this is not the purpose” of declaratory relief).

148. See *supra* note 125 and accompanying text.

149. See, e.g., *State Farm Fire & Cas. Co. v. Poomaihealani*, 667 F. Supp. 705, 707 (D. Haw. 1987) (stating that “the injured party should be allowed to control her own case” and that the declaratory judgment action would prevent the victim “from controlling the progress of her case” and deprive her “of her right to trial by jury”); *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 406, 347 A.2d 842, 849 (1975) (stating that permitting the declaratory judgment action would allow the defendant’s insurer, not the plaintiffs in the tort action, to control the litigation); *Morris v. Farmers Ins. Exch.*, 771 P.2d 1206, 1211 (Wyo. 1989) (noting that a declaratory judgment proceeding would “improperly allow the insurer to wrest control of the litigation from the injured party”). *But see* *Metropolitan Property & Liab. Ins. Co. v. Kirkwood*, 729 F.2d 61, 63 (1st Cir. 1984) (stating that, “[a]lthough [the plaintiffs in the tort suit] would prefer a tort trial, they have not explained how the declaratory judgment proceeding could otherwise work to their disadvantage”).

4. *The Undesirable Effects of Leaving the Coverage Issue Unresolved.*— Thus far, the declaratory judgment option seems undesirable in light of the goals of efficient loss-spreading and fairness between insurer and insured. But sticking to the complaint allegation rule as to overlapping facts also presents problems that must be considered. The complaint allegation approach for overlapping facts leaves the coverage issue unresolved throughout the pendency of the tort suit. This lack of resolution could have several unappealing effects: (1) enhancing the likelihood of structural collusion<sup>150</sup> between the tort plaintiff and the tort defendant;<sup>151</sup> (2) increasing the occasions when insurance funds are paid for harms that should be uninsurable;<sup>152</sup> (3) adding to the number of collateral disputes between insurer and insured or between insured and insurance defense counsel;<sup>153</sup> and (4) possibly, increasing the number of tort suits that are tried rather than settled.

Turning to the first, structural collusion refers to occasions when the presence of insurance diminishes or eliminates what otherwise would be the plaintiff's and defendant's opposition to each other on an issue or strategy in the tort suit.<sup>154</sup> A classic example is the plaintiff's choice to "underlitigate" an intentional tort as merely negligent, in order to evade the intentional harm exclusion in standard insurance policies.<sup>155</sup> Other examples include sweetheart agreements between plaintiffs and defendants that result after the insurer arguably has breached a duty to the insured.<sup>156</sup> Structural collusion can diminish the accuracy and integrity of the adjudicative process. In addition, it can result in insurance payments for harms that, for reasons of both efficiency and justice, should not be insurable.<sup>157</sup> The opportunities

150. Cf. John Coffee, *Rescuing the Private Attorney General: Why the Model of the Lawyer as County Hunter is Not Working*, 42 MD. L. REV. 215, 248 (1983) (applying the term "structural collusion" to collusion that results from the incentives generated by attorneys' fees in class actions).

151. See *infra* notes 154-156 and accompanying text.

152. See *infra* notes 157-158 and accompanying text.

153. See *infra* notes 159-160 and accompanying text.

154. See Coffee, *supra* note 150, at 248.

155. See Pryor, *supra* note 23, at 1721-23 (citing cases in which plaintiffs underlitigated in an attempt to avoid the intentional harm exclusion).

156. See Wood, *supra* note 113, at 1385-89 (discussing the potential problems created by sweetheart agreements). In my view, consent judgments following insurer breaches should often be allowed. This route can be abused, because the opportunity for such arrangements can give the parties an incentive to game the rules and to try to access insurance in doubtful coverage or underinsurance cases. These opportunities disappear, however, once the coverage issue is resolved.

157. Cf. Pryor, *supra* note 23, at 1740-45 (explaining that intentional harms are excluded so as to avoid moral hazard and inefficiency).

for this type of structural collusion diminish greatly once the coverage issue itself is resolved.<sup>158</sup>

Leaving the coverage issue unresolved also will increase the number of collateral disputes that can arise between insurer and insured (and between insured and defense counsel) over the handling of the tort suit itself. Depending on the jurisdiction, these collateral disputes can take the form of later tort litigation over the quality of the defense that the insurer provided,<sup>159</sup> the insurer's failure to settle the claim reasonably,<sup>160</sup> or professional malpractice by defense counsel. The point here is not to criticize the substantive law that allows such claims; much of this remedial scheme is justified. Rather, the point is that, without a lingering coverage issue, many of these disputes would not arise in the first instance.

The final possible effect noted above—increasing the number of suits that are litigated rather than settled—is a plausible theoretical conclusion for at least some cases involving unresolved coverage disputes.<sup>161</sup> In many tort cases, the defendant's uninsured assets will not be sufficient to satisfy all or at least a major part of the expected judgment. In such cases, how the coverage issue will be resolved is a question that is crucial to the parties' estimates of the expected value of

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158. *Id.* at 1756-58 (noting that, where the insurer is permitted to seek a declaratory judgment on the issue of coverage, "a resolution of the declaratory judgment proceeding will close many of the routes to insurance funding").

159. See JERRY, *supra* note 17, § 111[g] (discussing insurer's liability for inadequate defense).

160. See *supra* notes 73-76 and accompanying text.

161. The possible effect is one of the conclusions that could be drawn from an application of the economic model of trial and settlement. The model theorizes that litigants' choices are driven by their rational economic estimates of the likely judgment and the costs of proceeding to trial. See Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 417-20 (1973); Priest & Klein, *supra* note 70, at 12-17. The economic model is perhaps the most dominant account of settlement and trial behavior by parties. An alternative model makes heavy use of bargaining theory to explain why certain disputes proceed to trial rather than settle. Under this approach, trials frequently can be explained as the result of bargaining or negotiating gambits—such as unreasonably hard bargaining—that fail. See Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982). In addition, a considerable literature suggests refinements and additions to the economic theory. See, e.g., Russell Korobkin & Chris Guthrie, *Psychology, Economics, and Settlement: A New Look at the Role of the Lawyer*, 76 TEX. L. REV. 77 (1997) (arguing that the role of lawyers should be considered when analyzing how well the economic model explains the patterns of trial and settlement); Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113 (1996) (arguing that the economic model should be modified to take account of theories of cognitive psychology). A large literature also examines the empirical support for the economic model. See, e.g., Samuel R. Gross & Kent D. Syverud, *Getting to No: A Study of Settlement Negotiations and the Selection of Cases for Trial*, 90 MICH. L. REV. 319, 333-34 (1991).

the tort case.<sup>162</sup> The coverage question, moreover, is a separate variable from the variables of liability and damages. As a result, even when the parties to the tort suit are not far apart in their evaluations of liability and damage, they could diverge significantly on their estimates of success on coverage. Thus, in some cases, the parties' valuations of liability and damages might be sufficiently similar to allow a settlement,<sup>163</sup> but divergence over the coverage question might scuttle the chances of settlement.<sup>164</sup>

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162. The expected value of the tort case is the aggregate of a series of potential outcomes—for instance, that there is a 5% chance of a verdict in the range of \$500,000, a 25% chance of a verdict in the range of \$200,000, a 10% chance of a no-liability finding, etc. See Priest & Klein, *supra* note 70, at 6-12. When the likely judgments can be collected only against insurance, and when insurance coverage is questionable, then the expected value of the suit will be discounted by the uncertainty over coverage.

163. Under the economic model, a party will settle when the settlement exceeds the expected value of continuing with the litigation. For instance, suppose that the plaintiff's damages are \$200,000, that the plaintiff's chances of prevailing on liability are 15%, and that the costs of taking the case to trial are \$10,000 for the plaintiff and \$15,000 for the defendant. From the plaintiff's perspective, the expected value of the case is \$200,000 x .15, less the costs that the plaintiff will have to incur to take the case to trial; that is, \$20,000. From the defendant's perspective, the expected payout in the case is \$200,000 x .15, plus the costs of taking the case to trial; that is, \$45,000. The plaintiff will accept any offer that exceeds \$20,000, and the defendant will be willing to settle for any amount less than \$45,000.

Under the economic model, this case should settle unless (1) the parties' estimates of the expected value of the case diverge enough to close the window for settlement—for instance, the plaintiff in the above example calculates the chances of a favorable verdict as 60%, but the defendant calculates the chances as only 40%; (2) the parties have different nonmonetary stakes in the outcome—for instance, one party is particularly concerned about the precedential or reputational effect of a judgment. According to the influential work of George Priest and Benjamin Klein, divergent estimates of the expected outcome are more likely to block settlement in close cases; that is, when the case lies close to the "decision standard." Priest & Klein, *supra* note 70, at 17-22. For further analysis and testing of their hypothesis, see Gross & Syverud, *supra* note 161; Daniel Kessler et al., *Explaining Deviations From the Fifty-Percent Rule: A Multimodal Approach to the Selection of Cases for Litigation*, 25 J. LEGAL STUD. 233 (1996); Robert E. Thomas, *The Trial Selection Hypothesis Without the 50 Percent Rule: Some Experimental Evidence*, 24 J. LEGAL STUD. 209 (1995).

164. In one of the rare judicial discussions of how a lingering coverage question impacts the parties' incentives to settle the underlying case, a California federal district court agreed that addressing the coverage issue would increase the chances of settlement. But the court argued that this effect was undesirable.

The prospect that the only source of payment for a significant verdict will not be available after trial tends to coerce the tort claimant to come to the settlement bargaining table before the federal [declaratory judgment] action is adjudicated. There the tort claimant often will be met not only by the insurer, but also the insured. Faced with the immediate prospect of having to provide its own defense, and often with financial catastrophe if it is ultimately forced to respond to a major verdict without contribution from its insurer, the insured suddenly may be willing to make a major contribution to a settlement. Therefore, the result of the pressures created by the federal [declaratory judgment] action often may be to create a substantial possibility that the insurer will be able to force a settlement of the

5. *Other Considerations Under Declaratory Judgment Statutes.*—Federal and state courts, when considering whether to allow the declaratory judgment action to adjudicate extrinsic evidence, have looked to some considerations in addition to those already discussed. For federal courts, the primary such consideration is interference with the state litigation.<sup>165</sup> To some extent, this consideration implicates many of the same factors already discussed, including the impact of the declaratory judgment option on the insured's defense, the possible disadvantages of leaving the coverage issue unresolved, and so forth. Yet this consideration is independently significant because it signals a preference against interference when the justification for or benefits of that interference are weak or unclear.<sup>166</sup> And, as we have seen, the declaratory judgment option is very troublesome for several reasons. Thus, if the declaratory judgment option is properly viewed as interfering with state court litigation, then the federal preference against interference strengthens—even if it does not entirely resolve—the case against the declaratory judgment option.

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state court action in which it is required to contribute only a fraction of the value of its potential economic exposures.

Zurich Ins. Co. v. Alvarez, 669 F. Supp. 307, 310-11 (C.D. Cal. 1987) (footnote omitted). This is essentially an argument that we should prefer a regime under which carriers have to pay the value of the tort claim undiscounted by doubts about coverage. See also North E. Ins. Co. v. Northern Brokerage Co., 780 F. Supp. 318, 322 (D. Md. 1991) (arguing that while insurance coverage might be relevant to settlement of the tort claim, "it is no more relevant to settlement than are the underlying issues of liability and damages" so that "there is no reason why resolution of the coverage issue should be given priority").

This view seems misguided. Sometimes coverage is not available because the underlying conduct cannot or should not be insured at an actuarially fair price. Thus, a regime that does not take coverage doubts into account would override coverage limitations that are efficient and fair. In addition, even when coverage limitations are the result of mistaken purchasing decisions by insureds, it is better to address this problem directly than to prefer a regime that generally postpones consideration of coverage doubts.

165. See *Wilton v. Seven Falls Co.*, 515 U.S. 277, 283 (1995) (reasoning that, "at least where another suit involving the same parties and presenting opportunity for ventilation of the same state law issues is pending in state court, a district court might be indulging in '[g]ratuitous interference,' if it permitted the federal declaratory action to proceed" (citation omitted) (alteration in original) (quoting *Brillhart v. Excess Ins. Co.*, 316 U.S. 491, 495 (1942)); *Nationwide Ins. v. Zavalis*, 52 F.3d 689, 697 (7th Cir. 1995) (finding that the "relatively discrete nature of the inquiry necessary in order to resolve [the duty to defend issue] poses no demonstrable need to engage in any extensive discovery or factfinding that might interfere with the . . . action in state court"); *State Farm Fire & Cas. Co. v. Mhoon*, 31 F.3d 979, 984 (10th Cir. 1994) (noting that "entertaining State Farm's summary judgment motion involved no undue interference with the state proceeding").

166. See, e.g., *Zavalis*, 52 F.3d at 694 (stating that the federal court presiding over the declaratory judgment action on the duty to defend should not decide whether the insured acted intentionally or negligently, because this is a factual dispute "that should be left to the court presiding over the underlying tort action").

The declaratory judgment option does implicate the issue of interference. If the insurer, in the declaratory judgment proceeding, joins the state tort plaintiff as defendant, then the declaratory judgment might have collateral estoppel effect on an issue in the state tort suit.<sup>167</sup>

Notice, however, that many overlapping fact contexts will not present this problem. First, the insurer might not join the tort plaintiff. Second, even if the tort plaintiff is joined, the factual or legal issues to be decided in the declaratory judgment action might be distinct from those to be decided in the tort suit, even if some facts are relevant to both. An example is whether an insured's polluting activities were sudden and accidental. The tort suit will not adjudicate the issues of suddenness or the policy's definition of "accident." Rather, the tort suit will adjudicate only the issues of negligence, gross negligence, and so forth. Certain facts will be relevant both to the issues in the declaratory judgment action and to the issues in the tort action. But a declaratory judgment would not resolve the same issues. Nonetheless, the interference concern adds some weight to the case against the declaratory judgment option.

Another possible concern is that adjudication of the coverage issue is premature. The argument begins with the point that allowing the adjudication of the duty to defend by means of extrinsic evidence would be tantamount to adjudicating the coverage question. Although this point is correct, it does not follow that adjudication of coverage is premature until *resolution* of the underlying lawsuit. This contention is based on the following reasoning: there is no liability unless and until the tort suit produces a judgment or settlement for the plaintiff, the issue of coverage is entirely irrelevant unless and until the tort suit produces a judgment or settlement for the plaintiff, and thus the issue of coverage is irrelevant until the outcome of the tort suit.<sup>168</sup> This reasoning fails to take into account the insurer's defense obligation, which is triggered at the outset of the suit. If insurers were allowed to adjudicate a coverage contention before the completion of the tort suit, the insurer could be relieved of further defense costs. Thus, it is incorrect to say that the coverage issue implicates no actual controversy until the completion of the tort suit.<sup>169</sup>

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167. See *supra* note 114.

168. See *Aetna Cas. & Sur. Co. v. PPG Indus., Inc.*, 554 F. Supp. 290, 296 (D. Ariz. 1983).

169. A number of courts have rejected this prematurity argument. See, e.g., *Indemnity Ins. Co. v. Ridenour*, 629 So. 2d 1053, 1054 (Fla. Dist. Ct. App. 1993) (per curiam) (noting that requiring the insurer to provide a defense when it has no obligation to do so may pose an irreparable injury).

This is not meant as an argument that the insurer *should* be allowed to adjudicate the coverage issue before the completion of the tort suit. Indeed, as explained earlier, allowing this is very troublesome.<sup>170</sup> Rather, the point is that the declaratory judgment option should not be disallowed solely on the flawed premise that the coverage issue is irrelevant until the outcome of the tort suit. It could be relevant to the defense obligation, if we chose to allow that obligation to be defeated by extrinsic facts.

6. *Devising a Declaratory Judgment Approach to Overlapping Extrinsic Facts.*—Each of the possible approaches to overlapping extrinsic evidence has significant problems. Allowing use of overlapping extrinsic evidence would sometimes be inconsistent with the level of litigation insurance that, *ex ante*, insureds would prefer.<sup>171</sup> But the alternative—disallowing the adjudication of the duty to defend by means of extrinsic evidence in a declaratory judgment action—allows coverage disputes to linger throughout the tort litigation. This may have all the undesirable effects just outlined. We lack empirical information about many of the points that would help us evaluate the weight of these concerns. We do not know, for instance, how often allowing the declaratory judgment action to proceed would undermine the insured's tort defense; how often an unresolved coverage dispute would cause the tort case to be tried rather than settled; or how significantly the resolution of the coverage dispute would reduce the amount of structural collusion or collateral disputes.

In light of these uncertainties, the most defensible and workable approach is to apply a general presumption against allowing the declaratory judgment action to adjudicate the duty to defend—and hence the coverage issue—on the basis of overlapping extrinsic facts. The term “overlapping extrinsic facts” refers to any facts extrinsic to the complaint that are relevant both to (1) coverage and (2) liability or damages in the tort suit. This presumption could be overcome by the insurer's showing that allowing the action to proceed would not potentially weaken the insured's defense on liability or damages. This would be the case if the insurer's efforts to develop facts or arguments relating to coverage could not undermine the strength of the insured's defense on liability or damages in the tort suit.<sup>172</sup>

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170. See *supra* notes 132-139 and accompanying text.

171. See *supra* notes 126-139 and accompanying text.

172. When federal courts entertain declaratory judgment actions simultaneously with state tort suits, a relevant concern is interference with the state court process. See *supra* notes 165-167 and accompanying text. One might cite this concern and argue that, in these contexts, the insurer should never be allowed to seek adjudication of overlapping



This approach is similar to that endorsed by some commentators and courts in recent years.<sup>173</sup> For instance, Colorado courts will not allow the declaratory judgment action to proceed unless it “concern[s] issues that are independent of and separable from those in the underlying case.”<sup>174</sup> Kansas courts do not allow the declaratory judgment if it would adjudicate a key issue in the underlying suit.<sup>175</sup>

It is important to appreciate that the proposed approach does not relate to occasions when the insurer seeks a declaratory judgment based only on the complaint allegation approach. The declaratory judgment action concerning the duty to defend should be allowed to proceed even in overlapping fact cases if the insurer seeks only a ruling that, on the basis of the complaint allegation rule, it owes no duty to defend.<sup>176</sup>

### III. COVERAGE-ONLY SITUATIONS

How should the defense obligation be structured with respect to factual or legal allegations that relate only to coverage and not to the underlying suit? Courts have followed a number of approaches. Probably a majority continue to apply the eight-corners rule at the outset,

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extrinsic facts. Yet the approach advocated in the text should adequately address concerns about federal interference with the state process. The court will adjudicate an overlapping extrinsic fact only in the relatively rare case when it does not potentially undermine the insured's defense in the tort suit.

173. See Howard, *supra* note 118, at 37 (arguing that “[w]hen no such danger [of prejudicing the insured or claimant] is realistically posed, the [declaratory judgment action] may proceed before the parallel action is tried”).

174. *Constitution Assoc. v. New Hampshire Ins. Co.*, 930 P.2d 556, 562 (Colo. 1996); see also *Indemnity Ins. Co. v. Ridenour*, 629 So. 2d 1053, 1054 (Fla. Dist. Ct. App. 1993) (per curiam) (allowing the declaratory judgment action when it “requires the resolution of facts largely extraneous to those alleged in and necessary to the plaintiff's case”); *State Farm Fire & Cas. Co. v. Shelton*, 531 N.E.2d 913, 917 (Ill. App. Ct. 1988) (stating that, under Illinois law, the declaratory judgment court “must not determine disputed factual issues that are crucial to the insured's liability in the underlying personal injury lawsuit”); *American Motorists Ins. Co. v. Artra Group, Inc.*, 338 Md. 560, 594, 659 A.2d 1295, 1311 (1995) (allowing the declaratory judgment because there are “no issues to be determined at trial which are intertwined with” the coverage issue).

175. See *State Farm Fire & Cas. Co. v. Finney*, 770 P.2d 460, 466 (Kan. 1989) (recognizing two specific instances of potential prejudice in “requiring the insured to litigate the key issues in the underlying suit in a declaratory judgment action against his own insurance company”). Notice that this approach might allow the declaratory judgment to proceed in more cases than the approach endorsed in text.

176. See, e.g., *Nationwide Ins. v. Zavalis*, 52 F.3d 689, 694-95 (7th Cir. 1995) (explaining why the court could adjudicate the duty to defend in an intentional harm case without looking beyond the allegations in the complaint); *State Farm Fire & Cas. Co. v. Mhoon*, 31 F.3d 979, 984-85 (10th Cir. 1994) (explaining why, even in a shooting case involving allegations of intentional conduct, the duty to defend could be decided in the declaratory judgment proceeding on the basis of the complaint allegation rule).

but then allow the insurer to adjudicate the coverage issue by means of extrinsic evidence in a declaratory judgment action before the completion of the tort suit.<sup>177</sup> Some courts follow limited versions of an actual facts approach. For instance, some allow the insurer to rely on actual facts with respect to limited types of coverage issues, such as whether the defendant has insured status or the vehicle was insured under the policy.<sup>178</sup> Another limited approach allows the insurer to rely on the actual facts if the coverage-relevant allegation is contradicted by known or readily ascertainable facts,<sup>179</sup> is obviously false,<sup>180</sup> or is clearly motivated only by a desire to access insurance.<sup>181</sup>

To determine the optimal structure of the defense obligation with respect to coverage-only situations, we should again look at what rational insureds would wish to purchase by way of defense insurance. Specifically, would the insured wish to purchase a defense insurance policy governed entirely by the eight-corners rule, even as to coverage-only allegations?

Consider a prospective insured who is offered two types of *indemnity* coverage. Policy *A* has indemnity coverage for injuries arising from the business use of the boat, but the coverage costs more. Policy *B* has indemnity coverage for injuries arising only from the personal use of the boat, not from business use. The insured, let us suppose, chooses *B*, either because he does not anticipate using the boat in connection with business, or because he knows that he will be indemnified by some other source for any liabilities connected to business uses.

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177. See 2 WINDT, *supra* note 72, § 8.03, at 4 (stating this approach and citing cases that follow it).

178. See *Shelton*, 531 N.E.2d at 919 (stating that an actual facts approach can be used only if the coverage issue relates to "such ancillary matters as whether the insured paid the premiums or whether he is the proper insured under the policy").

179. See *Rowell v. Hodges*, 434 F.2d 926, 929-30 (5th Cir. 1970) (*per curiam*) (rejecting the notion that the duty to defend is governed by the complaint allegation rule when "the uncontrovertible and indisputable facts, ascertained by the insurance company long before the action is commenced and confirmed by its own insured, demonstrate that there never was any insurance coverage for the casualty alleged in the first place"); *American Motorists Ins. Co. v. Trane Co.*, 544 F. Supp. 669, 678 (W.D. Wis. 1982) (interpreting Wisconsin law to allow an exception to the complaint allegation rule when the facts known by or readily ascertainable by the insurer conflict with the pleadings), *aff'd*, 718 F.2d 842 (7th Cir. 1983).

180. See *Liberty Mut. Ins. Co. v. Metzler*, 586 N.E.2d 897, 901 (Ind. Ct. App. 1992) (noting that, under Indiana law, it is "well settled that where an insurer's independent investigation of the facts underlying a complaint against its insured reveals a claim patently outside of the risks covered by the policy, the insurer may properly refuse to defend").

181. See *State Farm Ins. Co. v. Trezza*, 469 N.Y.S.2d 1008, 1012 (Sup. Ct. 1983) (stating that, where a "complaint has been drafted in bad faith and designed solely to bring an insurer into a case," a court would be warranted in allowing examination of the facts).

What kind of defense insurance will the insured purchase? One option would be defense insurance governed entirely by the complaint allegation rule, even for coverage-only allegations, as distinct from liability-relevant allegations. Under this option, the insured would be furnished a defense *whenever the complaint alleges* that the boat was being used only in connection with personal and not business uses. A second option would provide a defense only if, *according to the actual facts*, the boat was being used in connection with personal and not business reasons. The second option would cost less than the first.

Keeping in mind that this insured has chosen indemnity coverage that does not extend to business uses of the boat, the second option would be the more desirable one. It is cheaper. It contains the core protection that this insured wants: the insurer must defend against all accidents arising out of nonbusiness uses of the boat, and the insurer cannot escape a defense just because the lawsuit lacks substantive or legal merit. Only in one circumstance will the first option provide defense insurance when the second will not: The insured was in fact using the boat in connection with business pursuits, but the complaint alleges that the insured was using the boat in connection with personal uses only. Is this additional insurance worth the cost? Remember, we have assumed that this insured, for various reasons, opted against indemnity insurance for business-related accidents. For these same reasons, the insured would not be willing to pay a higher price for litigation insurance that essentially provides this same indemnity coverage.

Thus, with respect to coverage-only allegations, in theory the insured would prefer defense insurance not governed solely by the complaint allegation approach. We still must choose a doctrinal alternative. Two choices are possible:<sup>182</sup> (1) the actual facts and not

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182. Another choice is to use some type of limited exception to the eight-corners rule, as some courts seem to do. *See, e.g., American Motorists*, 544 F. Supp. at 678 (noting that, under Wisconsin law, when a conflict exists between the alleged facts and those that the insurer knows or can readily ascertain, "the court may consider facts known at the appropriate time by the insurer when determining whether the insurer has breached its duty to defend"). Yet these limited exceptions have complexities that are not justified by the benefits of the rule. For instance, the "known or readily ascertainable" approach requires an assessment of which facts the insurer knew or could readily ascertain at the time the defense was tendered to the insurer. This is far more complicated an inquiry than the yes-no question of coverage. Likewise, exceptions that are triggered only by "patently false" allegations or by a plaintiff's motivation to access insurance require an inquiry, respectively, into the extent of the truth or falsity of the allegations, and the plaintiff's subjective state of mind. None of these complexities seems worth any possible benefits of these limited exceptions. In all likelihood, these limitations stem from a fear that broadening the bounda-

the alleged facts govern from the very outset; or (2) the complaint allegation rule governs at the outset, but the insurer may adjudicate, by means of extrinsic evidence, the duty to defend in a declaratory judgment proceeding.<sup>183</sup> Under the first approach, the insurer would be free to deny the duty to defend on the basis of the actual facts; the denial would breach the duty to defend only if the insurer turned out to be wrong on the coverage question. For instance, suppose the insurer denied a defense based on its contention that the boat was being operated in connection with business and not personal purposes. If the insurer prevailed on the business use contention in the eventual suit between insurer and insured on coverage, its denial of a defense would not constitute a breach of the duty to defend. Conversely, if the insurer lost on the coverage contention, its denial of a defense would be a breach of the duty to defend.

Both versions have some disadvantages. The first—that actual facts govern from the outset—is acceptable in theory, since it matches the level of defense insurance that is optimal in theory.<sup>184</sup> Under this approach, the defense obligation will extend even to cases that are doubtful on their merits; insurers will generally not be allowed to contest the defense obligation on the basis of overlapping extrinsic facts; and, with respect to coverage-only facts, the insurer will be obligated to provide a defense when there is indemnity coverage. Yet the approach raises some practical concerns. It depends on a distinction between coverage-only and overlapping facts. The distinction is generally workable and understandable, and declaratory judgment courts in many jurisdictions have been employing it for some time.<sup>185</sup> Still, abandoning the eight-corners rule for coverage-only allegations would elevate the practical import of the distinction. No longer would the distinction be simply one factor that courts use in deciding how to exercise their discretion with respect to declaratory judgment actions. Rather, the distinction would form part of the liability rule: the in-

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ries of the complaint allegation rule will not provide sufficient protection to the insured. As explained in the text, however, the suggested approach confers adequate protection on the insured.

183. This is the approach taken by most courts. *See, e.g.*, *Montrose Chem. Corp. v. Superior Court*, 861 P.2d 1153, 1157-65 (Cal. 1993) (in bank) (examining multiple California appellate cases, and holding that an insurer, in a declaratory judgment action, may look to extrinsic evidence to determine its duty to defend the insured).

184. *See supra* text accompanying note 182.

185. *See, e.g.*, *Constitution Assoc. v. New Hampshire Ins. Co.*, 930 P.2d 556, 562 (Colo. 1996) (requiring that a declaratory judgment action concern “issues that are independent of and separable from those in the underlying case”); *Indemnity Ins. Co. v. Ridenour*, 629 So. 2d 1053, 1054 (Fla. Dist. Ct. App. 1993) (per curiam) (distinguishing between facts concerning the issue of coverage and facts in the tort plaintiff’s complaint).

surer would breach the duty to defend if it incorrectly viewed a set of facts as relating only to coverage. The distinction might not always be clear. Even so, however, if the insurer were sued in such a case for failure to defend, whether the basis of the denial related only to coverage or overlapped with the underlying suit could and should be determined as a matter of law.

The second approach—that the complaint allegation rule governs at the outset—would avoid the adjudicative costs of carving out a coverage-only exception to the eight-corners rule. But, under the second approach, the insurer would be required to defend up until the time it obtained an adjudication of no coverage. This defense obligation raises the concerns discussed earlier: the opportunity for structural collusion between the tort plaintiff and insured defendant, and disputes about the manner in which the insurer or defense counsel conducted the defense.<sup>186</sup>

On balance, the actual facts approach seems preferable.<sup>187</sup> It delivers the appropriate level of defense insurance in theory, and the usual breach of contract and extracontractual remedies would be available for mistakes or abuses in the application of the approach.<sup>188</sup> Indeed, as just noted, it appears that many courts have been applying something akin to this approach by allowing the actual facts to govern, from the outset, with respect to questions such as the identity of the insured or the insured vehicle.<sup>189</sup>

To make clear how the approach would work, consider again a case involving the business purposes exclusion. Suppose the insurer receives notice of a suit alleging that the boat was being driven in connection with personal uses at the time of the accident. Or perhaps the suit does not make any particular allegation as to business versus personal use, and the issue is ambiguous. The insurer, however, has some preliminary facts suggesting that the accident occurred during a business use of the boat. The insurer is not certain of this, and has not yet conducted a thorough investigation of the point.

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186. See *supra* notes 154-160 and accompanying text.

187. Some analysts have endorsed this approach. See Ashley, *supra* note 8, at 201 (concluding that “[i]f the insurer has doubts about coverage based on coverage-determining facts, it should have the right to refuse to defend”); Barker, *Dissident Thoughts*, *supra* note 8, at 118 (arguing against “imposing a duty to defend based on doubts as to coverage-determining facts extrinsic to the underlying litigation”).

188. See *supra* notes 108-110 (providing examples of extracontractual protections in the form of statutes, regulations, and common law bad faith protections).

189. See *supra* note 185 and accompanying text (citing cases in which courts distinguished between coverage-only and overlapping facts).

Suppose the insurer denies a defense on the basis of the business uses exclusion. This will not be a breach of the duty to defend if (1) the contested legal and factual issues relating to the coverage issue cannot affect the strength or weakness of the insured's defense in the underlying tort suit; and (2) the insurer prevails in a factual adjudication of the business versus personal use issue. Whether the first condition is satisfied is a question of law; whether the second condition is satisfied depends on how the coverage issue is adjudicated.

The first condition will not always be an easy call. But this difficulty does not render the suggested approach unworkable. Instead, it creates an incentive for insurers to employ an actual facts approach only when it is quite clear that the coverage-relevant allegation has no bearing on the strength or weakness of the plaintiff's tort suit. When there is an overlap, or when the insurer is unsure whether an overlap exists, the insurer should apply the eight-corners rule rather than the actual facts approach. The insurer then can seek to litigate the coverage issue by means of extrinsic facts in the declaratory judgment proceeding. The question of overlap then becomes the court's call.

#### CONCLUSION

The mechanism of defense insurance allocates and spreads a significant slice of the transaction costs generated by the tort liability system. Thus, its scope and structure implicate concerns of fairness and efficiency for both potential and actual defendants. In addition, defense insurance also shapes the conduct and strategies of tort plaintiffs, insured defendants, insurers handling tort defenses, and insurers denying tort defenses and undertaking coverage litigation. It generates a large quantity of collateral litigation over the insurer's bad faith in not defending, the insurer's mishandling of the defense, and the misconduct of defense counsel retained by the insurer. And, because defense insurance can influence whether payment to the tort victim occurs, this form of insurance affects the fairness and efficiency objectives of the tort liability system.

A close look at the theory and structure of defense insurance illuminates these consequences of defense insurance. In addition, it explains and justifies many of the current features of defense insurance, including its frequent—though not universal—bundling with indemnity insurance and its close—although not identical—similarity to the scope of indemnity insurance.

The biggest puzzle of defense insurance is its decisional structure, which differs from that of all other forms of first-party insurance. The insurance policy language, contrary to the assumptions of many

courts, is indeterminate with respect to the appropriate decisional structure when a coverage issue exists. The standard interpretive tools applied to insurance language also do not persuasively support the decisional approach that most courts follow. In addition, some reasons that have traditionally been advanced for the current approach do not withstand inspection.

Nonetheless, defense insurance in some cases does require a different decisional structure. These are the cases in which the coverage-relevant facts on which the insurer would rely are also at issue in the underlying tort suit. In these cases, an insured who pursued the carrier for denial of a defense would be in the position of gaining an additional adversary on an issue that could undermine the insured's defense in the tort suit. This is a concern distinct from that which inheres in all insurance contexts—a dispute between insurer and insured—and which we address with potent extracontractual remedies. Instead, in the overlapping context, the insured might suffer a harm that cannot be undone with the traditional remedies. For this reason, the Article has argued that the complaint allegation approach is appropriate in such cases, and that generally courts should decline to consider a declaratory judgment action that seeks to adjudicate the coverage issue while the tort suit is pending.

In other cases, however, the insurer's reason for doubting coverage is not connected to the issues at stake in the tort suit. In these nonoverlapping contexts, this Article has demonstrated that insureds *ex ante* would desire defense insurance governed by the actual, not the alleged, facts relating to coverage. Thus, the only reasons to retain the complaint allegation rule in such contexts are concerns about wrongful denials and the adjudicative costs of distinguishing between overlapping contexts and nonoverlapping contexts. Yet these concerns are not sufficient to sustain the use of the complaint allegation rule in nonoverlapping cases. Indeed, many courts already have departed from a complaint allegation rule to at least some extent in such contexts.

Despite this trend, the contours of defense insurance are unsettled or unstable in a number of jurisdictions, and the theory and rationales for the various current approaches remain quite divergent. With a richer understanding of the theory and structure of defense insurance, we will be better equipped to implement the defense obligation in a way that is consistent with the efficiency and fairness objectives of the tort liability regime.