"LITIGATION INSURANCE": CONSEQUENCES OF AN INSURANCE COMPANY'S WRONGFUL REFUSAL TO DEFEND

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I. INTRODUCTION

When a consumer purchases liability insurance coverage in any of its various forms, such as a homeowner's policy, business or automobile policy, the consumer expects to receive what was promised—an insurance company's promise to be "on [his] side,"[1] "[l]ike a good neighbor,"[2] providing a "piece of the rock,"[3] and placing him "in good hands."[4] At least a part of the sense of security the newly insured feels is based on the contractual obligation that the insurance company will defend any claims against the insured that fall within coverage.[5] The insured assumes the insurance company, experienced as it is in the world of litigation, will rally the troops to take care of the insured, as its advertising promises that it will.

If someone files a liability claim against the insured that arguably falls within coverage but the insurance company wrongly[6] refuses to defend, the

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1. Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claim Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1405 (1994).
2. *Id.* at 1404.
3. *Id.*
4. *Id.* at 1403; *see also infra* notes 13 & 15.
5. *See* discussion *infra* notes 11-15.
6. Although an insured suffers the same difficulties when the insurance company

insured sees how illusory those advertisement promises really are. Abandoned by the insurance company when help is needed most, the insured finds he has not a piece of the rock, but quicksand; not a good neighbor, but a fair-weather friend; he does not stand with an experienced insurance company and its stable of attorneys on his side, but he stands alone. Instead of being in the good hands he sought, protected from the emotional and financial ravages of litigation, the insured lost the security, peace of mind, and protection he thought he had wisely purchased with his premium dollar.

To compound the insured's predicament, his remedies for the insurance company's breach of its duty to defend may be limited by a court that does not recognize the reality of the liability insurance context—that the insured purchased litigation insurance,[7] not just as an economic product, but as a peace-of-mind product.[8] In short, the insured may lose more in attorneys' fees, judgment or settlement amount, consequential damages, and emotional distress than he can recover from the insurance company for breach of the duty to defend. The insurance company, by contrast, may find itself better off refusing to defend than undertaking the defense that may subject it to tort liability. Such a result violates a basic premise of contract damage awards, that the nonbreaching party should be placed in as good a position as he would have been had the contract been performed.[9]

In Part II, this Article examines the problem of inconsistent approaches to damages for failure to defend and then suggests in Part IV that the better approach to wrongful-failure-to-defend cases would be to allow the insured full compensation for all damages that naturally result from the insurer's breach under a contract approach. Reaching this result requires an examination of the insurer's obligation to defend in Part III, and an examination of foreseeable consequences of its refusal to do so in light of the expectations of the insured in Part V.

II. THE PROBLEM OF AN INSURER'S WRONGFUL REFUSAL TO DEFEND

Virtually every policy of primary liability insurance obligates the insurer to defend any claim brought against the insured, even a frivolous one, for which the policy provides coverage.[10] Indeed, the common insured

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correctly refuses to defend because the complaint does not raise an arguable basis for coverage, this article focuses exclusively on the consequences of a *wrongful* refusal to defend. *See* discussion *infra* Part III regarding determining the duty to defend.

7. *See infra* note 12.

8. *See* discussion *infra* notes 12-13.

9. 5 ARTHUR L. CORBIN, CORBIN ON CONTRACTS §§ 992, 1002 (1964 & Supp. 1994); 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.8, at 186 (1990).

10. The language of the standard policy generally provides some version of the following: "[The insurer] will defend any lawsuit, even if groundless, false or fraudulent, against any insured for such damages which are payable under the terms of this policy." Lujan v. Gonzales, 501 P.2d 673, 677 (N.M. Ct. App. 1972). *See, e.g.*, Montgomery Ward & Co. v. Pacific Indem. Co., 557 F.2d 51, 53 (3d Cir. 1977) ("'[T]he company shall have the *right and duty to defend* any suit against the insured seeking damages on account of such bodily injury or

purchases liability coverage not only for the indemnity benefits but also to avoid the costs of defending any claim that might be presented against him.[11] Unlike insurance companies which regularly and routinely defend lawsuits as part of their business, most individual insureds lack expertise in the judicial system. In reality, the policyholder purchases not only liability insurance but "litigation insurance" as well.[12]

A promise that the insurer will defend the insured and use its expertise offers the insured "peace of mind." This promised peace of mind creates

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property damage, even if any of the allegations of the suit are groundless, false or fraudulent . . . .'") (quoting contract between Pacific Indemnity Company and Royal Industries) (emphasis added); Safeway Moving & Storage Corp. v. Aetna Ins. Co., 317 F. Supp. 238, 246 n.6 (E.D. Va. 1970) ("As respects the insurance afforded by the other terms hereof the Company shall: (a) defend any suit against the Insured alleging such injury or destruction and seeking damages on account thereof, even if such suit is groundless, false or fraudulent . . . .") *aff'g with modifications*, 452 F.2d 79 (4th Cir. 1971); State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 950 (Ariz. Ct. App. 1979) ("[The insurance company] agrees . . . to defend, with attorneys selected by and compensated by the company, any suit against the insured alleging such bodily injury or property damage and seeking damages which are payable hereunder even if any of the allegations of the suit are groundless, false or fraudulent."). *See also* ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 111[a] (1987) (explaining the source of the duty of an insurer to defend its insured); ALLAN D. WINDT, INSURANCE CLAIMS AND DISPUTES § 4.01 (2d ed. 1988) (explaining both the right and obligation of an insurance company to defend the insured).

11. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d at 950 ("'A purchaser of liability insurance has a right to expect not only indemnification at the end but also a shield against liability claims at the outset.'") (quoting Orleans Village v. Union Mut. Fire Ins. Co., 335 A.2d 315, 318 (Vt. 1975)); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 759 (N.D. 1980) ("[T]he defense and vindication of an insured by his insurance carrier against third-party claims is one of the chief benefits of the insurance contract."); Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156, 160 (W. Va. 1986) ("[The insured] purchased the insurance policy to be protected from incurring attorneys' fees and expenses arising from litigation."); Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 5 (Wis. 1993) (stating that indemnification and defense are primary benefits insured receives for premiums).

12. JERRY, *supra* note 10, § 111[a]; *see also* Hutchinson Oil Co. v. Federated Serv. Ins. Co., 851 F. Supp. 1546, 1552 (D. Wyo. 1994) ("[Liability insurance] is, in effect, litigation insurance provided in the policy in addition to the general indemnity coverage.") (quoting First Wyo. Bank v. Continental Ins. Co., 860 P.2d 1064, 1073-74 (Wyo. 1993)); Hoechst Celanese Corp. v. National Union Fire Ins. Co., No. 89C-SE-35, 1994 WL 721614, at *3 (Del. Super. Ct. April 6, 1994) ("Under a comprehensive general liability policy, the duty to defend an insurance claim and the duty to indemnify are provided for under two separate and distinct clauses. The defense clause provides the insured with litigation insurance in the event a claim is filed against him."); International Paper Co. v. Continental Cas. Co., 320 N.E.2d 619, 621 (N.Y. 1974) ("An insurer's obligation to furnish its insured with a defense is heavy indeed, and, of course, broader than its duty to pay."); Erica Trading Corp. v. Nathan Butwin Co., 420 N.Y.S.2d 87, 88 (Sup. Ct. 1979) ("The commercial policy that plaintiff obtained through the defendant was not merely 'liability insurance' but included 'litigation insurance', as well."); First Wyo. Bank v. Continental Ins. Co., 860 P.2d 1064, 1073 (Wyo. 1993) ("The duty to defend, which is an independent consideration in liability insurance, is created by the policy terms and arises when a claim is made against the insured. It is, in effect, litigation insurance provided in the policy in addition to the general indemnity coverage.") (citations omitted).

one of the incentives for purchasing liability coverage.[13] Indeed, insurance companies market their products with an appeal to the public's desire for peace of mind.[14] Such advertising reflects the idea that the relationship between the insured and the insurer involves more than just a contract of indemnification for economic loss.[15]

When an insurance company refuses to defend,[16] the insured loses the

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13. As the California Supreme Court stated in *Crisci v. Security Insurance Co.*:

> [The insured] did not seek by the [insurance] contract involved here to obtain a commercial advantage but to protect herself against the risks of accidental losses, including the mental distress that might follow from the losses. Among the considerations in purchasing liability insurance, as insurers are well aware, is the *peace of mind and security* it will provide in the event of an accidental loss, and recovery of damages for mental suffering has been permitted for breach of contracts which directly concern the comfort, happiness or personal esteem of one of the parties.

Crisci v. Security Ins. Co., 426 P.2d 173, 179 (Cal. 1967) (emphasis added); *see also* Tan Jay Int'l Ltd. v. Canadian Indem. Co., 243 Cal. Rptr. 907, 912 (Ct. App. 1988) (reiterating the holding in *Crisci v. Security Ins. Co.* which states that among the "considerations in purchasing liability insurance . . . is the peace of mind and security it will provide . . . ."); Andrew Jackson Life Ins. Co. v. Williams, 566 So. 2d 1172, 1174-75 (Miss. 1990) (acknowledging the role that "peace of mind" plays in purchasing insurance contracts); Beck v. Farmers Ins. Exch., 701 P.2d 795, 802 (Utah 1985) ("[I]t is axiomatic that insurance frequently is purchased not only to provide funds in case of loss, but to provide peace of mind for the insured or his beneficiaries."); Campbell v. State Farm Mut. Auto. Ins. Co., 840 P.2d 130, 139 (Utah Ct. App.) ("[A]n insured may purchase insurance not only to provide funds, but to provide peace of mind."), *cert. denied*, 853 P.2d 897 (Utah 1992).

The Oregon Supreme Court has rejected an insured's argument that peace of mind forms one component of an insurance contract for which the insured should be compensated upon breach by damages for emotional distress. Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1021-22 (Or. 1978). The court found the argument logically flawed because many contracts for services, materials, and financial assistance also include an element of economic peace of mind. *Id.* at 1022.

14. *See supra* text accompanying notes 1-4.

15. *See* Irion v. Prudential Ins. Co., 765 F. Supp. 337, 338 n.2 (N.D. Tex. 1991) ("Plaintiff, at the inducement of Prudential, got herself a 'piece of the rock,' and now that it's time for the insurance company to pay, Prudential wants to take its rocks and go home."); Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1028-29 n.4 (Or. 1978) (dissenting opinion); D'Ambrosio v. Pennsylvania Nat'l Mut. Cas. Ins. Co., 396 A.2d 780, 786 (Pa. Super. Ct. 1978) ("The insurer's promise to the insured . . . to put him in 'good hands,' to back him with a 'piece of the rock' or to be 'on his side' hardly suggests that the insurer will abandon the insured in his time of need."), *aff'd*, 431 A.2d 966 (Pa. 1981); *see also* Baker, *supra* note 1, at 1403-04 (reciting insurance marketing slogans, after which the writer states: "What is so interesting about these slogans, and about insurance advertising generally, is how directly they address the dependency dynamic in the insurance relationship."); Robert H. Jerry, II, *Remedying Insurer's Bad Faith Contract Performance: A Reassessment*, 18 CONN. L. REV. 271, 298-99 (1986) (stating that insurers emphasize the "peace of mind" that insurance affords when selling their products).

16. This paper focuses on a decision not to defend the insured that violates the insurance company's contractual obligation to defend. See discussion of that obligation in Part III. Granted, when the claim against the insured falls outside the scope of coverage and the insurance company correctly refuses to defend, the insured still suffers the consequences of no

benefit of the litigation insurance, as well as the indemnification promised by the liability policy. The consequences can be quite severe when the insurance company abandons the insured to defend the suit alone. Such results may include default judgment, judgment in excess of policy limits,[17] and attorneys' fees incurred for defense of the case. The insured may suffer financial straits, distress concerning the lawsuit and the financial strain of defending and paying any judgment, and deterioration of mental and physical health. The insured may also have to pay attorneys' fees to defend or prosecute a declaratory judgment action to determine the insurer's obligation to defend.[18]

In some jurisdictions, the insured can recover only the attorneys' fees expended in defense of the liability suit and the amount of a reasonable settlement or judgment up to the policy limits.[19] In other jurisdictions, the insured may be able to recover for all these consequences of the company's breach, and perhaps exemplary damages as well.[20]

The inequities involved in recoverable damages for wrongful refusal to defend illustrate the need to re-examine the insurance company's contractual obligation to defend its insured, the consequences to both insured and insurer of a wrongful refusal to defend, and appropriate remedies for such refusal to defend.

III. THE DUTY TO DEFEND

Numerous courts have recited the "practically universally recognized"[21] principle that the duty to defend is independent from and broader than the duty to indemnify.[22] The duty to indemnify is conditioned upon a

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defense or indemnification. Absent breach of the duty to defend, however, no remedy applies to those consequences; the policy holder simply is uninsured.

17. A judgment that exceeds the policy limits is often referred to as an "excess judgment."

18. *See* Michael J. Brady & Susan H. Hamdelman, *Insurer's Right to Reimbursement: Neglected but Valuable Remedy*, 59 DEF. COUNS. J. 547, 549 (1992) (stating that some courts have held that an insurer later determined to have no duty to pay the claim may recover costs incurred).

19. *See* discussion *infra* Part IV.

20. *See* discussion *infra* Part IV.

21. Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co., 230 A.2d 21, 24 (Conn. 1967).

22. *See, e.g.*, Servants of the Paraclete, Inc. v. Great Am. Ins. Co., 857 F. Supp. 822, 829 (D.N.M. 1994) ("The obligation of an insurance company to indemnify is independent of its obligation to defend. . . . If the allegations on the face of the complaint are 'potentially' or 'arguably' within the scope of coverage, the insurer is obligated to defend.") (citations omitted); Allstate Ins. Co. v. Vavasour, 797 F. Supp. 785, 787 (N.D. Cal. 1992) (applying California law) ("The duties to defend and to indemnify are not co-extensive. The duty to defend is generally broader than the duty to indemnify; where there is any possibility of coverage, the insurer is duty-bound to defend.") (citation omitted); Oliver B. Cannon & Son, Inc. v. Fidelity & Cas. Co., 484 F. Supp. 1375, 1385 (D. Del. 1980) ("The duty to defend under Pennsylvania law is very broad, often extending well beyond the duty to indemnify. There may even be an obligation to defend although there is no obligation to indemnify.") (citation omitted); Continental Cas. Co. v. Synalloy Corp., 667 F. Supp. 1563, 1582 (S.D. Ga. 1986) (stating

finding of liability against the insured, while the duty to defend arises unconditionally upon the filing of a claim against the insured that is arguably within policy coverage regardless of the ultimate determination of liability under the policy. This universal principle may require an insurer to defend an action for which it would not be obligated to pay any damages.[23]

To determine when the obligation to defend is triggered, courts generally take one of three approaches. Under the first approach, some courts have held that the insurance company must defend whenever the allegations of the complaint are "potentially" within the scope of coverage.[24] The insurer may

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that the duty to defend is distinct and separate from the duty to indemnify) (citation omitted), *aff'd*, 826 F.2d 1024 (11th Cir. 1987); Universal Underwriters Ins. Co. v. Youngblood, 549 So. 2d 76, 78 (Ala. 1989) (holding that the duty to defend can be more extensive than the duty to pay); Conway v. Country Cas. Ins. Co., 442 N.E.2d 245, 247 (Ill. 1982) ("[A]n insurer's duty to defend and its duty to indemnify are separate and distinct and . . . the former duty is broader than the latter.") (citations omitted); Western Cas. & Sur. Co. v. Adams County, 534 N.E.2d 1066, 1068 (Ill. App. Ct. 1989) ("The duty to defend is much broader than the duty to indemnify.") (citations omitted); Spruill Motors Inc. v. Universal Underwriters Ins. Co., 512 P.2d 403, 408 (Kan. 1973) (noting that policy language does not uniformly define the duty to defend as equal to the extent of coverage, the court stated that "[t]he result may be to extend the duty to defend beyond the extent of coverage"); Palmer v. Pacific Indem. Co., 254 N.W.2d 52, 55 (Mich. Ct. App. 1977) ("[I]t has been the law that the duty to defend a suit is independent of the limits of the policy coverage.") (citations omitted); State Farm Fire & Cas. Co. v. Price, 684 P.2d 524, 528 (N.M. Ct. App. 1984) ("The obligation of an insurance company to pay is independent of its obligation to defend.") (citation omitted); Fitzpatrick v. American Honda Motor Co., 575 N.E.2d 90, 92 (N.Y. 1991) (stating that "the duty to defend is broader than the duty to indemnify") (citations omitted); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 759 (N.D. 1980) ("An insurer's obligation to defend and an insurer's obligation to indemnify are separate and distinct contractual elements.") (citations omitted); Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156, 160 (W. Va. 1986) ("[I]t is generally recognized that the duty to defend an insured may be broader than the obligation to pay under a particular policy. This ordinarily arises by virtue of language in the ordinary policy that obligates the insurer to defend even though the suit is groundless, false, or fraudulent.") (citations omitted); First Wyo. Bank v. Continental Ins. Co., 860 P.2d 1064, 1073 (Wyo. 1993) (stating that "the duty to defend is more extensive than the duty to indemnify") (citations omitted); *see also* 7C JOHN ALAN APPLEMAN & JEAN APPLEMAN, INSURANCE LAW AND PRACTICE § 4691, at 256-58 (Walter F. Berdal ed. 1979) (outlining the view of courts that the insurer's duty to defend is broader than its duty to indemnify); JERRY, *supra* note 10, § 111[a] ("As between the duty to pay proceeds and the duty to defend, the more expansive duty is the duty to defend.").

23. JERRY, *supra* note 10, § 111[a]; *see, e.g.*, Fitzpatrick v. American Honda Motor Co., 575 N.E.2d at 92.

24. *See, e.g.*, Lucker Mfg. v. Home Ins. Co., 23 F.3d 808, 813 (3d Cir. 1994) (applying Pennsylvania law); Pacific Group v. First State Ins. Co., 841 F. Supp. 922, 934 (N.D. Cal. 1993); Allstate Ins. Co. v. Vavasour, 797 F. Supp. at 787; Cuson v. Maryland Cas. Co., 735 F. Supp. 966, 969 (D. Haw. 1990); Twin City Fire Ins. Co. v. Home Indem. Co., 650 F. Supp. 785, 789 (E.D. Pa. 1986); Beckwith Mach. Co. v. Travelers Indem. Co., 638 F. Supp. 1179, 1186 (W.D. Pa. 1986); Oliver B. Cannon & Son, Inc. v. Fidelity & Cas. Co., 484 F. Supp. at 1385 (applying Pennsylvania law); Safeway Moving & Storage Corp. v. Aetna Ins. Co., 317 F. Supp. 238, 246 (E.D. Va. 1970) (holding that there is a duty to defend when allegations of complaint may result in coverage), *aff'g with modifications*, 452 F.2d 79 (4th Cir. 1971); Hoechst Celanese Corp. v. National Union Fire Ins. Co., No. 89C-SE-35, 1994 WL 721614, at *3 (Del. Super. Ct. April 8, 1994); Conway v. Country Cas. Ins. Co., 442 N.E.2d

not refuse to defend with impunity unless the policy unequivocally excludes coverage.[25] The second approach used by courts relies expressly on the "four corners" of the complaint brought against the insured.[26] Courts using

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245, 247 (Ill. 1982); Posing v. Merit Ins. Co., 629 N.E.2d 1179, 1183 (Ill. App. Ct. 1994) ("'If the underlying complaints allege facts within or *potentially* within policy coverage, the insurer is obliged to defend its insured even if the allegations are groundless, false, or fraudulent . . . . An insurer may not justifiably refuse to defend an action against its insured unless it is *clear* from the face of the underlying complaints that the allegations fail to state facts which bring the case within, or potentially within, the policy's coverage.'") (citations omitted) (quoting United States Fidelity & Guar. Co. v. Wilkin Insulation Co., 578 N.E.2d 926, 930 (Ill. 1991)); Ottumwa Hous. Auth. v. State Farm Fire & Cas. Co., 495 N.W.2d 723, 726 (Iowa 1993); Independent Sch. Dist. No. 697 v. St. Paul Fire & Marine Ins. Co., 515 N.W.2d 576, 580 (Minn. 1994) (holding that insurer has duty to defend if any part of claim is "arguably" within coverage) (citing Brown v. State Auto & Cas. Underwriters, 293 N.W.2d 822, 825 (Minn. 1980)); State Farm Fire & Cas. Co. v. Price, 684 P.2d 524, 528 (N.M. Ct. App. 1984) ("The insurance company is obligated to defend when the complaint filed by the claimant alleges facts potentially within the coverage of the policy.") (citations omitted).

25. For example, the court in *State Farm Fire & Cas. Co. v. Price* explained the duty to defend: "The test is not the ultimate liability of the insurance company . . . but is based solely on the allegations of the complaint. . . . Only where the allegations are completely outside policy coverage may the insurer justifiably refuse to defend." State Farm Fire & Cas. Co. v. Price, 684 P.2d at 528 (citing 14 GEORGE J. COUCH ET AL., COUCH CYCLOPEDIA OF INSURANCE LAW §§ 51:52, :42, :45, :46, :55 (2d ed. 1982)); *see also* Servants of the Paraclete, Inc. v. Great Am. Ins. Co., 857 F. Supp. at 829; Twin City Fire Ins. Co. v. Home Indem. Co., 650 F. Supp. at 789, 791 (applying Pennsylvania law); Gray v. Zurich Ins. Co., 419 P.2d 168, 177 (Cal. 1966); State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 88 Cal. Rptr. 246, 257 (Ct. App. 1970); Hoechst Celanese Corp. v. National Union Fire Ins. Co., No. 89C-SE-35, 1994 WL 721614, at *3 (Del. Super. Ct. April 8, 1994); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1247 (Wash. 1987) (holding that insurer was obligated to defend unless the alleged claims were "clearly not covered").

In an interesting Alabama case involving the exclusion of coverage for injury "either expected or intended" by the insured, the Alabama Supreme Court reversed a summary judgment that had absolved the insurer of any duty to defend the insured, who had shot and killed another person. Jackson v. State Farm Fire & Cas. Co., 661 So. 2d 232 (Ala. 1995). Although recognizing the insured shot in self-defense, the majority found a genuine issue of disputed fact surrounding whether the insured subjectively intended to harm the deceased. *Id.* at 233. Thus, the insurer could not say the allegations were clearly not covered and therefore had to defend. *Id.*

26. *See, e.g.*, Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co., 230 A.2d 21, 24 (Conn. 1967) (holding that the insurer's duty to defend depends upon whether the complaint states facts which appear to bring a third person's claimed injury within policy coverage); Voorhees v. Preferred Mut. Ins. Co., 588 A.2d 417, 420 (N.J. Super. Ct. App. Div. 1991) (holding that duty to defend is determined by the nature of the complaint, not the details of the accident or ultimate liability), *aff'd*, 607 A.2d 1255 (N.J. 1992); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d at 1247 (holding that insurer was obligated to defend if the suit against the insured alleges facts which, if proven, would render the insurer liable); Talarico v. Foremost Ins. Co., 712 P.2d 294, 295-96 (Wash. 1986) (stating that duty to defend arises if allegations of complaint would render insurer liable; here, no coverage for allegations, thus no duty to defend); Farmers Ins. Group v. Johnson, 715 P.2d 144, 147 (Wash. Ct. App. 1986) (holding that an insurer has a duty to defend its insureds if their complaint alleges an event covered in their policy); Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 5 (Wis. 1993) (stating that the duty to defend is determined by the allegations in the four corners of the complaint);

the third approach require the insurer to defend if it knows of facts that bring the allegations of the complaint against the insured within coverage.[27] Conversely, facts that tend to negate coverage cannot excuse the duty to defend when the allegations of the complaint fall within coverage.[28]

The allegations of the complaint and policy provisions are central to a determination of the obligation to defend regardless of the specific approach taken to trigger the obligation.[29] Further, under any of these three approaches, courts applying the general rules of interpretation have held that ambiguous policy language cannot be asserted to insulate the insurer from its duty to defend.[30] Foremost among those general rules is the mandate that any ambiguities in the policy language or complaint should be construed in

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First Wyo. Bank v. Continental Ins. Co., 860 P.2d 1064, 1073 (Wyo. 1993) (setting out that duty to defend arises from the allegations in the complaint and not from the ultimate facts proven at trial).

27. *See, e.g.*, Transport Ins. Co. v. Michigan Mut. Liab. Ins. Co., 340 F. Supp. 670, 676 (E.D. Mich. 1972) (stating that the duty to defend depends upon the true facts of the case and not an ill-founded complaint), *modified on other grounds*, 496 F.2d 265 (6th Cir. 1974); Spruill Motors, Inc. v. Universal Underwriters Ins. Co., 512 P.2d 403, 407 (Kan. 1973) ("We adopt the rule . . . that an insurer must look beyond the effect of the pleadings and must consider any facts brought to its attention or any facts which it could reasonably discover in determining whether it has a duty to defend. If those facts give rise to a 'potential of liability' under the policy, the insurer bears a duty to defend."); American Gen. Fire & Cas. Co. v. Progressive Cas. Co., 799 P.2d 1113, 1116 (N.M. 1990) ("The duty of an insurer to defend arises from the allegations on the face of the complaint or from the known but unpleaded factual basis of the claim that brings it arguably within the scope of coverage."); Fitzpatrick v. American Honda Motor Co., 575 N.E.2d 90, 92 (N.Y. 1991) ("Indeed, in these circumstances, where the insurer is attempting to shield itself from the responsibility to defend despite its actual knowledge that the lawsuit involves a covered event, wooden application of the 'four corners of the complaint' rule would render the duty to defend narrower than the duty to indemnify—clearly an unacceptable result.").

28. *See, e.g.*, Servants of the Paraclete, Inc. v. Great Am. Ins. Co., 857 F. Supp. 822, 832 (D.N.M. 1994); Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co., 230 A.2d at 24-25; Sacharko v. Center Equities Ltd. Partnership, 479 A.2d 1219, 1221 (Conn. App. Ct. 1984); Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1304 (Fla. Dist. Ct. App. 1977).

The insurance company may assume the defense of such a case with a reservation of rights and file a declaratory judgment action in which it asserts known facts outside the complaint that negate coverage. *See* authorities cited *infra* note 34.

29. *See, e.g.*, Lucker Mfg. v. Home Ins. Co., 23 F.3d 808, 814 (3d Cir. 1994) (applying Pennsylvania law); Sportmart, Inc. v. Daisy Mfg. Co., 645 N.E.2d 360, 362 (Ill. App. Ct. 1994); Posing v. Merit Ins. Co., 629 N.E.2d 1179, 1182-83 (Ill. App. Ct. 1994) ("The standard for determining an insurer's duty to defend requires our review of the underlying complaints and our construction of the policy of insurance.") (applying the "potential" coverage approach) (citations omitted); Ottumwa Hous. Auth. v. State Farm Fire & Cas. Co., 495 N.W.2d 723, 726 (Iowa 1993) ("[O]ur task is to compare the pleadings . . . with the policies to determine whether an issue of potential or possible liability is generated under the terms of the policy."); State Farm Fire & Cas. Co. v. Price, 684 P.2d 524, 528 (N.M. Ct. App. 1984), *cert. denied*, 683 P.2d 44 (N.M. 1984).

30. *See* Allstate Ins. Co. v. Vavasour, 797 F. Supp. 785, 787 (N.D. Cal. 1992); Safeway Moving & Storage Corp. v. Aetna Ins. Co., 317 F. Supp. 238, 242 (E.D. Va. 1970), *modified and aff'd*, 452 F.2d 79 (4th Cir. 1971); State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 954 (Ariz. Ct. App. 1979).

favor of the insured.[31] The application of these general rules of policy construction requires a liberal reading of the policy and complaint to determine whether an obligation exists to defend the insured.[32]

Of course, where the allegations of the complaint clearly do not give rise to coverage, the insurer has no duty to defend.[33] If the insurer erroneously determines it does not have an obligation to defend,[34] it may be subjected to

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31. *See, e.g.*, Servants of the Paraclete, Inc. v. Great Am. Ins. Co., 857 F. Supp. at 831; Safeway Moving & Storage Corp. v. Aetna Ins. Co., 317 F. Supp. at 242; State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d at 954; Western Cas. & Sur. Co. v. Adams County, 534 N.E.2d 1066, 1068 (Ill. App. Ct. 1989) ("The complaint need not allege or use language affirmatively bringing the claims within the scope of the policy, as the question of coverage should not hinge exclusively on the draftsmanship skills or whims of the . . . [insurance company] . . . . The complaint against the insure[r] must be liberally construed. Any doubts about potential coverage are to be resolved in the insured's favor.") (citations omitted); Palmer v. Pacific Indem. Co., 254 N.W.2d 52, 55 (Mich. Ct. App. 1977); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1249 (Wash. 1987); Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156, 160 (W. Va. 1986); First Wyo. Bank v. Continental Ins. Co., 860 P.2d 1064, 1074 (Wyo. 1993).

32. *See, e.g.*, Hutchison Oil Co. v. Federated Serv. Ins. Co., 851 F. Supp. 1546, 1549 (D. Wyo. 1994); Allstate Ins. Co. v. Vavasour, 797 F. Supp. at 787 ("[A]n insurer must defend if ambiguous language in the policy leads the insured reasonably to expect that a defense will be provided.") (citations omitted); Hoechst Celanese Corp. v. National Union Fire Ins. Co., No. 89C-SE-35, 1994 WL 721614, at *3 (Del. Super. Ct. April 8, 1994) ("Any doubts as to an insurer's obligation to defend a claim against an insured should be resolved in favor of the insured."); Posing v. Merit Ins. Co., 629 N.E.2d 1179, 1183 (Ill. App. Ct. 1994); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d at 1249; Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d at 160 ("We have long recognized that since insurance policies are prepared solely by insurers, . . . any question concerning an insurer's duty to defend under an insurance policy must be construed liberally in favor of an insured where there is any question about an insurer's obligations.").

33. *See, e.g.*, Lucker Mfg. Inc. v. Home Ins. Co., 23 F.3d 808, 814 (3d Cir. 1994) (applying Wisconsin and Pennsylvania law); Richardson v. State Farm Fire & Cas. Co., 19 F.3d 29 (9th Cir. 1994) (applying California law); Ottumwa Hous. Auth. v. State Farm Fire & Cas. Co., 495 N.W.2d at 726; Spivey v. Safeco Ins. Co., 865 P.2d 182, 185 (Kan. 1993); Talarico v. Foremost Ins. Co., 712 P.2d 294, 295-96 (Wash. 1986).

34. To avoid liability for breach of the duty to defend, the insurer has basically three options. The insurer can: (1) defend under a reservation of rights and contest coverage in a separate declaratory judgment action; (2) defend without contesting coverage and waive the right to do so; or (3) follow the procedure of some courts that allow a stay of the liability case and a bifurcated trial on the coverage question. *See, e.g.*, Federated Ins. Co. v. X-Rite, Inc., 748 F. Supp. 1223, 1225 (W.D. Mich. 1990); CHI of Alaska, Inc. v. Employers Reinsurance Corp., 844 P.2d 1113, 1115-16 (Alaska 1993); Tapp v. Wrightsman-Musso Ins. Agency, 441 N.E.2d 145, 147 (Ill. App. Ct. 1982); Magoun v. Liberty Mut. Ins. Co., 195 N.E.2d 514, 517-18 (Mass. 1964); *see also* Alan I. Widiss, *Abrogating the Right and Duty of Liability Insurers to Defend Their Insureds: The Case for Separating the Obligations to Indemnify from the Defense of the Insureds*, 51 OHIO ST. L.J. 917, 924 (1990) (discussing the lawyer's three options when forced with insurance defense conflicts); Eric Mills Holmes, *A Conflict-of-Interests Roadmap for Insurance Defense Counsel: Walking an Ethical Tightrope Without a Net*, 26 WILLAMETTE L. REV. 1, 38-44 (1989) (enumerating the three options as set forth above).

A reservation of rights notice advises the insured that the insurance company will defend

liability for breach of contract.[35] Even an insurer's good faith belief that the policy did not cover the insured's claim, will not defeat a claim for breach of the duty.[36] Likewise, relying on a trial court decision that found there was no duty to defend because the insurance policy did not cover the insured's claim may not protect the insurer if that decision is reversed on appeal.[37]

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the insured but does not relinquish the right to contest coverage. It usually takes the form of a unilateral writing. An alternate method that accomplishes the same result is a nonwaiver agreement. A nonwaiver agreement is a contract between the insurer and the insured, signed by both insurer and insured, which acknowledges the insurer's right to contest coverage. Ward D. Smith, Comment, *Reservation of Rights Notices and Nonwaiver Agreements*, 12 PAC. L.J. 763, 764 (1981).

In some jurisdictions, under a reservation-of-rights defense, the insured becomes entitled to independent counsel. In other jurisdictions, the insurer must adhere to a heightened degree of good faith. The tendering of a reservation-of-rights defense, while preserving the right to challenge coverage, can result in conflicts of interest between the insured and the insurer. *See* Karon O. Bowdre, *Conflicts of Interest Between Insurer and Insured: Ethical Traps for the Unsuspecting Defense Counsel*, 17 AM. J. TRIAL ADVOC. 101, 114-28 (1993). Problems can arise with declaratory judgment actions. *See* Employer's Fire Ins. Co. v. Beals, 240 A.2d 397, 401-02 (1968) (discussing when a declaratory judgment is appropriate and when it is not); Note, *Use of the Declaratory Judgment to Determine a Liability Insurer's Duty to Defend–Conflict of Interests*, 41 IND. L.J. 87 (1965).

If the insurer undertakes the defense of the insured without reserving its rights to dispute coverage, it waives any known coverage defenses. *See, e.g.*, Federated Ins. Co. v. X-Rite, Inc., 748 F. Supp. at 1226; Beckwith Mach. Co. v. Travelers Indem. Co., 638 F. Supp. 1179, 1186 (W.D. Pa. 1986); Home Ins. Co. v. Rice, 585 So. 2d 859, 861 (Ala. 1991); Safeco Ins. Co. v. Ellinghouse, 725 P.2d 217, 221 (Mont. 1986); American Gen. Fire & Cas. Co. v. Progressive Cas. Co., 799 P.2d 1113, 1117 (N.M. 1990).

Some courts recommend a bifurcated trial on the question of damages. *See* Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 6 (Wis. 1993).

With the various options available to the insurer, it is difficult to understand why insurers risk being found to have wrongfully refused to defend when coverage is questionable. Indeed, the more prudent approach is to seek a judicial determination of the insurer's duty to defend.

35. *See, e.g.*, Caldwell v. Allstate Ins. Co., 453 So. 2d 1187, 1191 (Fla. Dist. Ct. App. 1984).

A claim against the insurance company for refusal to defend, like a claim for failure to settle within policy limits, arises from the duties in a liability insurance policy. Such claims are referred to as "third party claims" because the liability policy involves the defense and indemnification of claims asserted against the insured by third parties. By contrast, "first party claims" arise under policies in which the insurance company assumed an obligation to pay claims asserted by the insured. Examples of first party claims include those under life, medical, and fire insurance policies.

36. *See, e.g.*, Mullen v. Glenn Falls Ins. Co., 140 Cal. Rptr. 605, 610 (Dist. Ct. App. 1977); Lujan v. Gonzales, 501 P.2d 673, 678 (N.M. Ct. App. 1972); *see also* Caldwell v. Allstate Ins. Co., 453 So. 2d at 1189.

37. Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d at 6.

> An insurance company breaches its duty to defend if a liability trial goes forward during the time a no coverage determination is pending on appeal and the insurance company does not defend its insured at the liability trial. When an insurer relies on a lower court ruling that it has no duty to defend, it takes the risk that the ruling will be reversed on appeal.

Id.; see also Caldwell v. Allstate Ins. Co., 453 So. 2d at 1189 (reversing the lower court's summary judgment ruling that the insurer had no duty to defend its insured in a liability trial

IV. CONSEQUENCES OF BREACH OF DUTY TO DEFEND

A. *Consequences to the Insured*

An insurance company's refusal to defend an insured may result in serious consequences both to the insured and the insurer. The insured incurs the costs of attorneys' fees in defending the action brought against her when the insurer refuses to provide for a defense.[38] If the insured does not have the financial means to pay an attorney, the insured could face a default judgment[39] or an inadequate pro se defense. Insureds left on their own may have to take out loans and mortgage their homes to obtain defense and settlement funds.[40] Some insureds file for bankruptcy under the weight of the financial burden incurred as a result of providing their own defense because of the insurance company's refusal to defend.[41]

Insureds who have been abandoned by the insurance company may enter into a settlement agreement limiting liability and avoiding litigation expenses.[42] When facing the likelihood of a large judgment or facing execution of a large judgment against them, astute insureds frequently settle with the injured party, or agree to the entry of a judgment. In exchange for a release or a promise not to execute against the insureds, they assign the claim against the insurance company to the injured party.[43] The consequences of

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that was going forward during the time a no coverage determination was pending on appeal).

38. *See, e.g.*, Tan Jay Int'l, Ltd. v. Canadian Indem. Co., 243 Cal. Rptr. 907, 909 (Ct. App. 1988) (defending multi-million dollar litigation cost insured approximately $150,000 in attorneys' fees); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 760 (N.D. 1980) (alleging over $3,800 in attorneys' fees incurred).

39. *See, e.g.*, Holt v. Utica Mut. Ins. Co., 759 P.2d 623, 625 (Ariz. 1988); Robinson v. State Farm Fire & Cas. Co., 583 So. 2d 1063, 1065 (Fla. Dist. Ct. App. 1990); Caldwell v. Allstate Ins. Co., 453 So. 2d at 1188; Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1300 (Fla. Dist. Ct. App. 1977); Warren v. Farmers Ins. Co., 838 P.2d 620, 621-22 (Or. Ct. App. 1992); Wheelways Ins. Co. v. Hodges, 872 S.W.2d 776, 781 (Tex. Ct. App. 1994); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1246 (Wash. 1987).

40. *See, e.g.*, Safeco Ins. Co. v. Ellinghouse, 725 P.2d 217, 220 (Mont. 1986).

41. *See, e.g.*, Green v. J.C. Penney Auto Ins. Co., 806 F.2d 759, 761 (7th Cir. 1986).

42. *See* State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 950 (Ariz. Ct. App. 1979). Although an insured's agreement to the entry of a consent judgment or a settlement without the insurer's permission generally breaches the insured's contractual duty to cooperate, when the insurer has breached its duty to defend, the insured no longer must adhere to the contractual obligation of cooperation. *Id.* at 951.

43. *See, e.g.*, Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1129 (D.C. Cir. 1989) (applying North Carolina law); Green v. J.C. Penney Auto Ins. Co., 806 F.2d at 763; Cuson v. Maryland Cas. Co., 735 F. Supp. 966, 969-70 (D. Haw. 1990) (holding a claim for emotional distress could not be assigned by the insured but a claim for punitive damages was assignable); Holt v. Utica Mut. Ins. Co., 759 P.2d at 625 (Ariz. 1988) (recognizing the validity of an agreement for entry of judgment and assignment of the insured's claims against the insurer for failure to defend as a "Damron agreement" based on *Damron v. Sledge*, 460 P.2d 997 (Ariz. 1969)); Rogan v. Auto-Owners Ins. Co., 832 P.2d 212, 214 (Ariz. Ct. App. 1991); Clearwater v. State Farm Mut. Auto. Ins. Co., 780 P.2d 423, 426-27 (Ariz. Ct. App. 1989) (holding that personal claims could not be assigned but claim for punitive damages was

settlement or assignment, however, cause the insured to lose the very peace of mind that motivated the purchase of liability insurance in the first place.[44]

The damages sustained by the insured in *Crisci v. Security Insurance Co.*,[45] although a failure to settle case instead of a failure to defend case, illustrate the types of emotional suffering faced by an insured when the insurance company breaches its litigation obligations. In *Crisci,* the insurance company refused to settle a claim against Crisci knowing it would exceed her $10,000 policy limit.[46] At the conclusion of the action against Crisci, the jury returned a verdict against her for $101,000.[47] After the insurer paid the meager policy limits, several collection efforts were made against Crisci.[48] To resolve her obligations, she entered into an arrangement with the injured party for payment of $22,000, transfer of a partial interest in some property, and assignment of the claim against the insurance company.[49] The court noted: "Mrs. Crisci, an immigrant widow of 70, became indigent. She worked as a babysitter, and her grandchildren paid her rent. The change in her financial condition was accompanied by a decline in physical health, hysteria, and suicide attempts."[50]

The court affirmed an award of $25,000 for mental suffering, and noted that the insured:

> did not seek by the contract involved here to obtain a commercial advantage but to protect herself against the risks of accidental losses, including the mental distress which might follow from the losses. Among the considerations in purchasing liability insurance, as insurers are well aware, is the peace of mind and security it will provide in the event of an accidental

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assignable); State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d at 950; Wheelways Ins. Co. v. Hodges, 872 S.W.2d at 780 (holding that insured retained right to receive 25% of any exemplary damages recovered from the insurer); United Services Auto. Assoc. v. Pennington, 810 S.W.2d 777, 779 (Tex. Ct. App. 1991); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d at 1296; Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 4 (Wis. 1993).

44. *See, e.g.*, Tan Jay Int'l, Ltd. v. Canadian Indem. Co., 243 Cal. Rptr. 907, 913 (Ct. App. 1988) ("The fact is that Nygard's insurer (Canadian) abandoned him without justification in the face of a multi-million dollar third party claim, leaving him to face losing his reputation, his business, and his peace of mind gradually over a long period of time."); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 755 (N.D. 1980) ("Smith was upset and worried over the pending action, whether or not American Family would defend the action, and whether or not, if a verdict was [sic] rendered against Smith, American Family would pay the judgment to the limits of the insurance policy."); *see also supra* notes 12 & 13 and discussion of mental anguish damages *infra* Part V.D.

45. Crisci v. Security Ins. Co., 426 P.2d 173 (Cal. 1967).

46. *Id.* at 175.

47. *Id.* at 176.

48. *Id.*

49. *Id.* at 175-76.

50. *Id.* at 176; *see also* Campbell v. State Farm Mut. Auto. Ins. Co., 840 P.2d 130, 135-36 (Utah Ct. App.) (In this failure-to-settle case, the damages claimed by the insureds included: "depression, suicidal tendencies, embarrassment, humiliation and damage to reputation . . . physical injury attributable to their extreme emotional upset, including high blood pressure and aggravation of Parkinson's disease."), *cert. denied*, 853 P.2d 897 (1992).

> loss, and recovery of damages for mental suffering has been permitted for breach of contracts which directly concern the comfort, happiness or personal esteem of one of the parties.[51]

Not all courts allow recovery of damages for injury to one's peace of mind and sense of security.[52] When a court does recognize, however, that peace of mind plays a role in the purchase of liability coverage, it is a logical conclusion that breach of an insurance contract results in mental anguish. As a natural result of the breach and a consequence within the contemplation of the parties at the time of the contract,[53] mental distress should be recoverable for breach of the duty to defend.

Another problem faced by insureds when abandoned by their liability insurance companies is the potential of a default judgment. Default judgments against insureds are frequent when the insurer does not provide a defense. If the insured cannot afford an attorney, a default may be inevitable. The varied treatment of those default judgments merits some discussion.[54]

For example, in *Holt v. Utica Mutual Insurance Co.*,[55] the insured consented to a default judgment when the insurer delayed in presenting a defense.[56] The court held that a factual question precluded summary judgment regarding both the breach of the duty to defend by the insurer and breach of the duty of cooperation by the insured.[57] The court acknowledged,

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51. *Id.*

52. *See* discussion *infra* Part V.D.

53. The traditional measure of damages for breach of contract, which has its roots in *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854), allows the nonbreaching party to recover those damages naturally arising from the breach that were within the contemplation of the parties at the time of the making of the contract. 3 FARNSWORTH, *supra* note 9, § 12.14; CHARLES W. GAMBLE, ALABAMA LAW OF DAMAGES §§ 2-4 & 17-4 (3d ed. 1994). Another measure of damages, however, contradicts the *Hadley v. Baxendale* rule. In *New Orleans Ins. Assoc. v. Piaggio*, 83 U.S. (16 Wall.) 358, 360 (1873), the Supreme Court announced that, for breach of contract to pay money, the plaintiff could only recover the money owed, plus interest. The trend in measure of damages for breach of an insurance contract favors the *Hadley v. Baxendale* rule. Bob G. Freemon, Jr., *Reasonable and Foreseeable Damages for Breach of an Insurance Contract*, 21 TORT & INS. L.J. 108, 110 (1985). *See also* discussion *infra* Part V.D.

54. One of the most controversial cases involving a default judgment against an insured is *Stockdale v. Jamison*, 330 N.W.2d 389 (Mich. 1982). When the insurer refused to defend, the insured faced a default judgment in excess of the policy limits. *Id.* at 391. He then assigned his claims against the insurance company to the injured persons. *Id.* The court held that the assignees could recover whatever the insured could have recovered against the insurer. *Id.* at 393. Because the insured was judgment proof and the injured persons could not have recovered anything from him had they attempted execution against him, the court found that the insured was not damaged by the excess judgment and limited damages to the amount of the policy limits. *Id.* The court held that the measure of damages for the contractual duty to defend is "an amount equal to the insured's assets not exempt from legal process." *Id.* at 394.

The *Stockdale* decision was limited in *Frankenmouth Mut. Ins. Co. v. Keeley*, 447 N.W.2d 691 (Mich. 1989).

55. Holt v. Utica Mut. Ins. Co., 759 P.2d 623 (Ariz. 1988).

56. *Id.* at 626.

57. *Id.* at 627.

however, that if the insurer breaches its duty to defend the "insured may take reasonable steps to protect his or her interests. Depending on the circumstances, the insured may . . . even agree to the entry of a default judgment."[58]

If an insurance company breaches its duty to defend its insured, the subsequent default judgment should not be viewed as a breach of the insured's duty to cooperate. Under basic contract rules, a breach by one party relieves the non-breaching party of the obligations under the contract.[59] Therefore, a wrongful refusal to defend should relieve the insured of the contractual duties he would otherwise owe the insurer.[60] However, the insured may have a duty to mitigate damages.[61]

Whether the insured must take steps to mitigate damages, by undertaking a defense or having a default judgment set aside is an issue that arose in *Thomas v. Western World Insurance Co.*[62] In *Thomas*, the insurance company failed to notify the insured that it would not assert a defense on behalf of the insured until the day the answer was due.[63] The injured party took a default judgment against the insured for an amount in excess of policy limits.[64] The court found that the refusal to defend was unjustified and that a factual issue was present regarding the insurance company's bad faith.[65]

The court stated that, on remand, the insurer could affirmatively plead that the insured breached the obligation to mitigate damages by failing to hire counsel to initially respond or by failing to set aside the default judgment.[66] The court recognized that the insured may be excused from mitigation if the denial of defense came too late to hire counsel, or if the insured could not afford counsel.[67]

As the court indicated in *Thomas*, when evaluating a claim for failure to mitigate, the court will consider the insured's financial situation and the fact that the insured purchased insurance to avoid the very costs he faced when the insurance company defaulted on its obligation.[68] Further, the breach of the duty to defend could be the proximate cause of the default judgment if the denial of the defense came too late for the insured to secure counsel. In such a case, the default judgment should be viewed as the logical consequence of the breach.

Another issue that sometimes arises as a result of a judgment against the insured or a settlement with the injured party concerns the effect of a covenant between the insured and the injured party not to execute against the

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58. *Id.* at 629-30.
59. FARNSWORTH, *supra* note 9, § 8.6.
60. JERRY, *supra* note 10, § 111[h].
61. *Id.*
62. Thomas v. Western World Ins. Co., 343 So. 2d 1298 (Fla. Dist. Ct. App. 1977).
63. *Id.* at 1300-01.
64. *Id.* at 1300.
65. *Id.* at 1303-04.
66. *Id.* at 1302-03.
67. *Id.*
68. *Id.* at 1303-04.

insured's assets. A covenant not to execute protects the insured's property from execution in satisfaction of a judgment against the insured.[69] Although insurance carriers argue that covenants not to execute against insureds relieve the carrier of its obligation to pay because the insured no longer is liable to pay, the majority of courts reject the argument favoring instead the insured's right to make the best arrangement possible in a difficult situation.[70]

The Washington Supreme Court addressed the effect of a covenant not to execute in *Greer v. Northwestern National Insurance Co.*[71] The court rejected the insurance company's argument that the covenant relieved it of the obligation to indemnify because the insured was not legally liable for any amount as required by the policy to trigger the insurer's indemnity obligation.[72] Instead, the court concluded that "when an insurer has refused to defend its insured, it is in no position to argue that the steps the insured took to protect himself should inure to the insurer's benefit."[73]

When an insurance company abandons its insured to face litigation alone, the insured must make the best arrangement to protect herself from the consequences of litigation. Even the best arrangements do not eradicate the consequences of the insurer's refusal to defend. The insured may still suffer emotional distress, may have to incur attorneys' fees and expenses to force the insurance company to honor its obligation, and may face liability in excess of the policy limits. Whether the insured will be able to recover from the insurance company for these consequences of the insurer's refusal to defend depends in large measure on the jurisdiction.[74]

B. *Consequences to the Insurer*

The insurance company faces serious consequences if it makes an erroneous decision about its obligation to defend. Most courts recognize that

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69. A covenant not to execute can take various forms, all designed to protect the defendant's assets from execution to satisfy a judgment.

70. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 953 (Ariz. Ct. App. 1979) (holding that the covenant not to execute does not release the insurer from liability to its insured); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1251 (Wash. 1987) (adopting the majority judgment rule and holding that the insurer is not absolved of liability to its insured when a covenant not to execute exists). When the insured is not obligated to pay any portion of the judgment, courts are split as to the insurer's liability to the assignee. Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1131-32 nn.2 & 5 (D.C. Cir. 1989) (detailing the 27 states which support the judgment rule and the four states which support the payment rule). The split stems from whether courts adhere to the judgment rule or the payment rule. *Id.* at 1131. The majority of jurisdictions follow the judgment rule whereby the judgment against the insured presents prima facie evidence of the insurer's obligation. *Id.* at 1131 n.2. Under the payment rule, the insurer may offer evidence to show collusion because the insurer's liability is limited to "that portion of the judgment that equals 'the amount of [the insured's] assets not exempt from legal process.'" *Id.* at 1131-32 (quoting Stockdale v. Jamison, 330 N.W.2d 389, 390-91 (Mich. 1981)).

71. Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244 (Wash. 1987).

72. *Id.* at 1251.

73. *Id.*

74. *See infra* Part V.

an insurer that refuses to defend its insured does so at its own risk.[75] The consequences of a wrongful refusal to defend generally include forfeiture of the right to challenge the insured's compliance with policy provisions, such as forwarding suit papers to the carrier;[76] forfeiture of the defense that the insured failed to cooperate;[77] and forfeiture of the defense that the insured settled the claim without the insurer's consent.[78] Although an insurer cannot contest a settlement based on lack of consent, it may still challenge the reasonableness of the settlement.[79] In addition, the insurer loses the right to challenge the insured's liability or the right of the injured party to recover.[80] Finally, in a limited number of jurisdictions, a judicial finding of wrongful

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75. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 950 (Ariz. Ct. App. 1979); Caldwell v. Allstate Ins. Co., 453 So. 2d 1187, 1191 (Fla. Dist. Ct. App. 1984).

> Although an insurance company is certainly entitled to make a thorough investigation to determine whether there is coverage under its policy of insurance, the company acts at its peril in refusing to defend its insured in that if it is subsequently determined that the company erroneously denied coverage the company will be liable for damages for breach of its agreement under the policy.

Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 5 (Wis. 1993); *see also* JERRY, *supra* note 10, § 111[g][5].

In *Thomas v. Western World Insurance Co.*, the court stated: "An insurer which denies coverage does so at its own risk. This has been held to be true even where such denial is on a mistaken but honest belief that coverage did not exist." Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1304 (Fla. Dist. Ct. App. 1977). The court further explained that an "insurer at least impliedly represents it will be responsible for damages if it fails to provide the contracted for coverage and defense." *Id.* at 1304.

76. State Farm Fire & Cas. Co. v. Price, 684 P.2d 524, 531 (N.M. Ct. App. 1984); *see also* JERRY, *supra* note 10, § 111[g][7].

77. JERRY, *supra* note 10, § 85. The liability policy requires the insured to cooperate with the insurance company. This duty to cooperate usually forms a condition to the insurer's performance of its duties under the contract. *Id.* When the insurer breaches its duty to defend, the insured's duty to cooperate falls to the general contract principle that a breach by one party relieves the nonbreaching party from its contractual obligations. *See* Holt v. Utica Mut. Ins. Co., 759 P.2d 623, 628 (Ariz. 1988); State Farm Fire & Cas. Co. v. Price, 684 P.2d at 531; JERRY, *supra* note 10, § 111[g][7]; WINDT, *supra* note 10, § 4.36.

78. American Gen. Fire & Cas. Co. v. Progressive Cas. Co., 799 P.2d 1113, 1117 (N.M. 1990); State Farm Fire & Cas. Co. v. Price, 684 P.2d at 531; JERRY, *supra* note 10, § 111[g][5]; WINDT, *supra* note 10, § 4.36.

79. American Gen. Fire & Cas. Co. v. Progressive Cas. Co., 799 P.2d at 1118; State Farm Fire & Cas. Co. v. Price, 684 P.2d at 531.

80. Continental Cas. Co. v. Synalloy Corp., 667 F. Supp. 1563, 1582 (S.D. Ga. 1986). In *State Farm Mutual Automobile Insurance Co. v. Paynter*, the court stated:

> [I]n the absence of fraud or collusion, an insurance company which refuses to defend its insured is bound by a judgment against its insured . . . . By refusing to defend, the insurer takes the risk that it may have erred in determining that the policy did not provide coverage. Having refused to provide a defense, the insurer is said to have been "vouched in" the action against the insured and is bound by the judgment. In the absence of fraud or collusion, it is not entitled to relitigate the merits of the claim.

State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 950-51 (Ariz. Ct. App. 1979).

failure to defend precludes the insurer from challenging ultimate coverage.[81]

V. DAMAGES RECOVERABLE FOR WRONGFUL REFUSAL TO DEFEND

Damages paid by the insurer or recovered by the insured in a wrongful refusal to defend vary considerably from jurisdiction to jurisdiction. Most courts, however, recognize that insureds can recover basic contractual damages.[82] These damages generally include the following: the costs incurred in defense of the underlying suit, including attorneys' fees;[83] the amount of the judgment within policy limits[84] or a good faith reasonable settlement and

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81. Missionaries of Co. of Mary, Inc. v. Aetna Cas. & Sur. Co., 230 A.2d 21, 26 (Conn. 1967) ("The defendant, after breaking the contract by its unqualified refusal to defend, should not thereafter be permitted to seek the protection of that contract in avoidance of its indemnity provisions."); Sportmart, Inc. v. Daisy Mfg. Co., 645 N.E.2d 360, 364 (Ill. App. Ct. 1994). If the insurer refuses to defend a complaint that presents potential coverage without seeking a declaratory judgment or defending under a reservation of rights, the insurer may be estopped to deny coverage. *Id.* However, the insured must prove demonstrable prejudice. *Id.* The court in *Sportmart* held that because the insured could not show prejudice, the insurer was not precluded from contesting coverage. *Id.* at 365.

The use of estoppel to deny coverage against the insurer who wrongfully refused to defend is a minority view; indeed, the "vast majority" of cases hold that an unjustified failure to defend does not preclude the insurer from later contesting coverage. JERRY, *supra* note 10, § 111[g][6]; WINDT, *supra* note 10, § 4.35; *see also* Servants of the Paraclete, Inc. v. Great Am. Ins. Co., 857 F. Supp. 822, 833 (D.N.M. 1994) (following the majority rule); Alabama Farm Bur. Mut. Ins. Co. v. Moore, 349 So. 2d 1113, 1117 (Ala. 1977) (holding that the insurer's contractual duty to defend doesn't determine whether injury was intended or preclude contesting coverage); Polaroid Corp. v. Travelers Indem. Co., 610 N.E.2d 912, 922 (Mass. 1993) (stating that when an insurer's good faith refusal to defend an insured is ruled to be unjustified, normal contract rules are still applied); *see also supra* note 22 (discussing that the duty to defend frequently arises even though coverage may not ultimately exist).

82. *See infra* note 87.

83. Bostwick v. Foremost Ins. Co., 539 F. Supp. 517, 520 (D. Mont. 1982); Safeway Moving & Storage Corp. v. Aetna Ins. Co., 317 F. Supp. 238, 246 (E.D. Va. 1970), *modified and aff'd*, 452 F.2d 79 (4th Cir. 1971); Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co., 230 A.2d at 26; Conway v. Country Cas. Ins. Co., 442 N.E.2d 245, 247-48 (Ill. 1982); Spruill Motors, Inc. v. Universal Underwriters Ins. Co., 512 P.2d 403, 409 (Kan. 1973); Independent Sch. Dist. No. 697 v. St. Paul Fire & Marine Ins. Co., 515 N.W.2d 576, 580-81 (Minn. 1994); South Carolina Ins. Co. v. McKenzie, 547 So. 2d 25, 29 (Miss. 1989); American Gen. Fire & Cas. Co. v. Progressive Cas. Co., 799 P.2d 1113, 1117-18 (N.M. 1990); Lujan v. Gonzales, 501 P.2d 673, 682 (N.M. Ct. App. 1992); Kelmo Enters., Inc. v. Commercial Union Ins. Co., 426 A.2d 680, 685 (Pa. Super. Ct. 1981); United Servs. Auto. Ass'n v. Pennington, 810 S.W.2d 777, 784 (Tex. Ct. App. 1991); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1250 (Wash. 1987); Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156, 162 (W. Va. 1986) ("Most courts have held that where an insured is required to retain counsel to defend himself in litigation because his insurer has refused without valid justification to defend him . . . the insured is entitled to recover from the insurer the expenses of litigation, including costs and reasonable attorneys' fees."); Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 6 (Wis. 1993).

84. Greer v. Northwestern Nat'l Ins. Co., 743 P.2d at 1250. Cases addressing the recoverability of judgment amounts assessed against the insured that exceed policy limits are

interest on those amounts;[85] and other damages naturally flowing from the breach.[86] Differences among courts are most notable regarding whether insureds can recover for the attorneys' fees incurred in defending or prosecuting a declaratory judgment action or other litigation to determine the insurer's obligations;[87] for judgment amounts levied against the insured that exceed policy limits;[88] for the mental anguish insureds suffer when denied a defense;[89] or for punitive damages against the insurer.[90]

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discussed *infra* Part V. C.

85. Beckwith Mach. Co. v. Travelers Indem. Co., 638 F. Supp. 1179, 1190 (W.D. Pa. 1986); State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 954-55 (Ariz. Ct. App. 1979); Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co., 230 A.2d at 26; Greer v. Northwestern Nat'l Ins. Co., 743 P.2d at 1250; Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d at 6.

86. Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d at 6. When an insurer wrongfully refuses to defend,

> the insurer is guilty of a breach of contract which renders it liable to the insured for all damages that naturally flow from the breach . . . . Damages which naturally flow from an insurer's breach of its duty to defend include: (1) the amount of the judgment or settlement against the insured plus interest; (2) costs and attorney fees incurred by the insured in defending the suit; and (3) *any additional costs that the insured can show naturally resulted from the breach.* (emphasis added).

Id.; *see also* Green v. J.C. Penney Auto Ins. Co., 806 F.2d 759, 763 (7th Cir. 1986) (applying Illinois law); Pacific Group v. First State Ins. Co., 841 F. Supp. 922, 942 (N.D. Cal. 1993); Oliver B. Cannon & Son, Inc. v. Fidelity & Cas. Co., 484 F. Supp. 1375, 1386 (D. Del. 1980) (applying Pennsylvania law) ("If the insurance company breaches its contractual duty to defend, the normal rule of damages for breach of contract applies and the insurer will be liable to the insured for all damages directly resulting from the refusal to defend."); Transport Ins. Co. v. Michigan Mut. Liab. Ins. Co., 340 F. Supp. 670, 675-76 (E.D. Mich. 1972), *modified on other grounds*, 496 F.2d 265 (6th Cir. 1974); Safeway Moving & Storage Corp. v. Aetna Ins. Co., 317 F. Supp. 238, 246 (E.D. Va. 1970) ("[L]iability for additional damages above the contractual limits may be assessed against an insurer who wilfully refuses to honor its duty to defend, provided that the excess damages are the natural and probable result of the breach.") (citations omitted), *modified and aff'd*, 452 F.2d 79 (4th Cir. 1971); Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1304 (Fla. Dist. Ct. App. 1977) (The insurer "simply wrongfully refused to comply with its contract to provide a defense on behalf of its insureds. If that breach by [the] insurer caused foreseeable damages to be assessed against its insureds, to that extent the insurer should be held liable."); Conway v. Country Cas. Ins. Co., 442 N.E.2d 245, 249 (Ill. 1982) ("'[D]amages for a breach of the duty to defend are not inexorably imprisoned within the policy limits, but are measured by the consequences proximately caused by the breach.'") (quoting Reis v. Aetna Cas. & Sur. Co., 387 N.E.2d 700, 710 (Ill. App. Ct. 1978)).

For a general discussion of consequential damages for breach of insurance contracts and the trend toward recovery of these damages, see generally Freemon, *supra* note 53.

87. *See* cases discussed *infra* Part V.B.

88. *See* cases discussed *infra* Part V.C.

89. *See* cases discussed *infra* Part V.D.

90. Kocse v. Liberty Mut. Ins. Co., 377 A.2d 1234, 1237 (N.J. 1977) (denying punitive damages for failure to defend, and stating "courts are divided as to whether the general prohibition against punitive damages in contract actions applies to disputes involving insurance policies"); *see also* authorities discussed *infra* Part V.E.

A. *Contract or Tort?*

To some extent, the disparity in damages awarded to the insured can be explained by the approach taken by the jurisdiction in failure to defend cases. Some states view a refusal to defend as a pure breach of contract.[91] Other jurisdictions conclude that a refusal to defend can breach the good faith obligation inherent in all contracts, thus giving rise to a tort cause of action for bad faith failure to defend.[92] Still, in other jurisdictions, failure to defend gives rise to a contract cause of action, but the insured can recover extracontractual damages, such as mental anguish or punitive damages, only upon a showing of a tort separate from the breach of contract.[93]

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91. *See, e.g.*, Caldwell v. Allstate Ins. Co., 453 So. 2d 1187, 1191 (Fla. Dist. Ct. App. 1984); Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1302 (Fla. Dist. Ct. App. 1977); Independent Sch. Dist. No. 697 v. St. Paul Fire & Marine Ins. Co., 515 N.W.2d 576, 579 (Minn. 1994); Kocse v. Liberty Mut. Ins. Co., 377 A.2d at 1237-38; Farris v. United States Fidelity & Guar. Co., 587 P.2d at 1018; United Serv. Auto. Ass'n v. Pennington, 810 S.W.2d at 783; Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1247 (Wash. 1987); Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 6 (Wis. 1993).

Courts that restrict the cause of action to breach of contract and limit the damages recoverable to strict contractual damages view the insurance contract as merely a contract to pay money, with damages limited to the amount due under the contract plus interest. *See, e.g.*, Polito v. Continental Cas. Co., 689 F.2d 457, 461-62 (3rd Cir. 1982); Brown Township Mut. Ins. Ass'n v. Kress, 330 N.W.2d 291, 299 (Iowa 1983); Wilson v. Prudential Ins. Co., 528 P.2d 1135, 1139-40 (Okla. Ct. App. 1974). Damages for which insureds cannot recover under the traditional contract rule include attorneys' fees in enforcing the contract, emotional distress, and associated financial losses. *See* Baker, *supra* note 1, at 1424.

92. Green v. J.C. Penney Auto Ins. Co., 806 F.2d 759, 762 (7th Cir. 1986) (applying Illinois law) (holding that breach of contractual duty to defend *may* include bad faith that would subject the insurer to damages in excess of the policy limits); Tibbs v. Great Amer. Ins. Co., 755 F.2d 1370, 1375 (9th Cir. 1985) (holding that, while not every failure to defend constitutes bad faith, the evidence here was sufficient to show bad faith); Colemen v. Holecek, 542 F.2d 532, 538-39 (10th Cir. 1976); Conway v. Country Cas. Ins. Co., 442 N.E.2d 245, 249 (Ill. 1982) (holding that, absent a finding that the insurer acted in bad faith in refusing to defend, it could not be liable for a judgment in excess of policy limits); Smith v. American Family Ins. Co., 294 N.W.2d 751, 755-58 (N.D. 1980) (holding that wrongful failure to defend breaches the insurance contract, and may constitute a tort action if the insurer also breaches its obligation of good faith).

At least one court has recognized a cause of action for "negligent mishandling of an insurance claim" when an insurer wrongfully refuses to defend and settle a claim against the insured. Wheelways Ins. Co. v. Hodges, 872 S.W.2d 776, 780-82 (Tex. Ct. App. 1994).

93. Allstate Ins. Co. v. Vavasour, 797 F. Supp. 785, 789 (N.D. Cal. 1992) ("Tort damages are available against an insurer for refusing to defend a claim, even though refusing to defend constitutes a breach of contract, when the [insurer] breaches the implied covenant of good faith and fair dealing and is guilty of oppression, fraud or malice.") (citation omitted); Cuson v. Maryland Cas. Co., 735 F. Supp. 966, 968, 970 (D. Haw. 1990) (holding that no bad faith action exists for failure to defend, but insured could also recover emotional distress and punitive damages; implying that insured could not assign claim for emotional distress but could assign claims for punitive damages); State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 88 Cal. Rptr. 246, 257-58 (Ct. App. 1970); Liberty Mut. Ins. Co. v. Parkinson, 487 N.E.2d 162, 165 (Ind. Ct. App. 1985) ("Due to our development of this special contractual remedy which affords the insured a more generous measure of damages, we have found no reason to

An analysis of these cases reveals a discrepancy among the courts concerning the best way to treat a breach of a contractual provision causing damages beyond those normally viewed as compensable in breach of contract actions. One of the most cogent discussions of reasons for restricting relief to a breach of contract action over a tort approach was stated in *United Services Automobile Ass'n v. Pennington*.[94] The insured's assignee sued the insurer for "negligent handling of the claim by wrongfully refusing to defend its insured."[95] The court explained that for a tort duty to arise from a contractual duty, the liability must be independent of the existence of the contract.[96] In other words, "the defendant must breach a duty imposed by law rather than by contract."[97] Absent breach of an insurance contract provision that obligates the carrier to defend, no separate liability arises for failure to defend. Thus, a claim for failure to defend can only sound in contract, not tort.[98]

Another explanation for limiting the cause of action for refusal to defend a breach of contract recognizes that the insurer who refuses to perform its contractual obligation does not exercise any "faith" at all.[99] In refusing to perform, the insurer fails to undertake the contractual obligations agreed to under the policy and refuses to be saddled with any obligation to act in good faith. If the refusal to perform violates the contractual obligation, then the insurer should be held liable for reasonably foreseeable damages resulting from the breach.[100]

The Oregon Supreme Court similarly denied tort status for failure to defend in *Farris v. United States Fidelity & Guaranty Co.*[101] The court discussed the differences between failure to defend, which gives rise to a breach of contract claim, and failure to settle, which gives rise to a tort claim.[102] Because an insurer defending the insured faces a conflict of interest concern-

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adopt bad faith as an independent tort in this state and we see no need to adopt such an action now.").

94. United Serv. Auto. Ass'n v. Pennington, 810 S.W.2d 777 (Tex. Ct. App. 1991).

95. *Id.* at 783. Texas recognizes a cause of action for negligent handling of a claim against the insured by failing to settle. *Id.* (citing Ranger County Mut. Ins. Co. v. Guin, 723 S.W.2d 656 (Tex. 1987)).

96. *Id.*

97. *Id.* (citing Southwestern Bell Tel. Co. v. Delanney, 809 S.W.2d 493, 494 (Tex. 1991)).

98. *Id.*

99. Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1304 (Fla. Ct. App. 1977). The court faced the issue of whether bad faith was required to hold the insurer liable for a default judgment in excess of policy limits. The court, recognizing the split of authority among Florida's District Courts of Appeal, concluded that breach of the duty to defend was contractual and that a showing of bad faith was not a prerequisite to liability in excess of the policy limits. *Id.* at 1304. The cases upon which the insurer relied for its argument that bad faith was a requirement for liability for a judgment in excess of policy limits were in the context of the insurer's failure to settle within policy limits, as opposed to liability for failure to perform the duty to defend at all. *Id.* at 1303.

100. *Id.* at 1304-05.

101. Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015 (Or. 1978).

102. *Id.* at 1018.

ing an opportunity to settle, courts impose a duty of good faith on an insurer in evaluating settlement options.[103] When the insurer undertakes the defense of the insured, the insurance company acts in a fiduciary capacity.[104] In contrast, when an insurer refuses to defend its insured, it also refuses to undertake the fiduciary obligations.[105] The court concluded, therefore, that the rationale supporting a tort action for bad faith failure to settle did not apply to an action for failure to defend.[106]

Because the *Farris* court found that there was no fiduciary obligation involved in a failure to defend, the court ignored another reason that courts give for recognizing a tort action for failure to settle: the insurance company retains the *right* to determine whether to settle any claim against the insured.[107] Because the insurer has retained the right to settle, the insurer must exercise its decision whether to settle in good faith, giving consideration

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103. *Id.*

104. *Id.* at 1019.

105. *Id.*

106. *Id.* at 1018-19. For criticism of the *Farris* doctrine, see *Warren v. Farmers Ins. Co.*, 838 P.2d 620, 623 (Or. Ct. App. 1992). The court observed:

> There is much appeal to [the insured's] argument, which is supported by cases that she cites from other jurisdictions. In all fairness, it is difficult to see why the insurer should be in a better position by refusing to defend and thereby breaching the insurance contract than it would have been had it undertaken the defense but done so negligently. We fail to see any principled distinction between the conflict of interest that exists when an insurer makes a decision whether to defend and the conflict that exists when, having undertaken the defense, a settlement opportunity arises that would cost the insurer its policy limits but would result in no personal liability for the insured. Were we writing on a clean slate, we might reach a different result. However, *Farris* dictates the result in this case: If an insurer does not defend a claim, and thereby breaches its contract with the insured, its liability, if any, is only for breach of contract, not for a tort.

Id. at 623-24.

In Justice Lent's dissenting opinion in *Farris*, he noted:

> In fact, under the majority opinion in *this* case of bad faith refusal to perform the liability insurance contract, all the insurer has to lose is the costs and losses it would have borne anyway if it had accepted the case. If anything, a liability insurer intending to breach its contract in bad faith is encouraged to do so at the outset rather than risk the tort liability applicable to bad faith breaches *in performance.*

Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1028 (Or. 1978) (Lent, J., dissenting).

107. For example, the standard form of automobile liability provides: "We will settle or defend, as we consider appropriate, any claim or suit asking for these damages." INSURANCE SERVICES OFFICES, INC., PERSONAL AUTO POLICY FORM (1985). The standard commercial liability policy contains a similar retention of the right to control defense and settlement: "We may investigate and settle any claim or 'suit' at our discretion." INSURANCE SERVICES OFFICES, INC., COMMERCIAL GENERAL LIABILITY COVERAGE FORM (1982 & 1984).

See also JERRY, *supra* note 10, § 112; Barney v. Aetna Cas. & Sur. Co., 230 Cal. Rptr. 215, 219 (Ct. App. 1986); Cernocky v. Indemnity Ins. Co., 216 N.E.2d 198, 204 (Ill. App. Ct. 1966).

to the interests of the insured.[108] Similarly, the insurance policy asserts *the right and duty* to defend the insured; therefore, insurer "stands in a fiduciary relationship toward the insured and is obligated to act in good faith and with due care in representing the insured's interests."[109] Furthermore, the obligation of good faith inherent in insurance contracts suggests one overriding obligation of good faith, not just the obligation to approach settlement opportunities in good faith.[110]

Other courts, when examining an insurance carrier's failure to defend its insured, have concluded that breach of the contractual obligation to defend may also constitute the tort of bad faith.[111] The courts recognize the existence of a tort action for failure to comply with the contractual obligation because a tort remedy grants the insured the ability to recover extra-contractual damages and because the recovery provides a deterrent effect.[112] When an insured can recover only traditional contractual damages, the insured does not receive full compensation for the damages sustained as a result of the insurer's breach. If the insured's damages are limited to contractual damages, the insurer has little incentive to defend when its only liability is what it would have had to expend to defend the case.[113] As one court noted, denying recovery in tort for the insurer's refusal to defend would "encourage insurance companies to exert whatever coercion in whatever manner and under whatever circumstances as would serve their financial interest, and . . . would leave the [insured] without a remedy for damages for the failure to defend beyond attorney's fees and legal costs."[114]

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108. *See* JERRY, *supra* note 10, § 112.

109. Beckwith Mach. Co. v. Travelers Indem. Co., 638 F. Supp. 1179, 1188 (W.D. Pa. 1986) (citing Gray v. National Mut. Ins. Co., 223 A.2d 8 (Pa. 1966)).

110. As one court noted in a failure to settle case, "[t]here is no legal distinction between the duty of good faith owed by an insurance company when dealing with first party claims or third party claims. There is one overall duty of good faith, and bad faith is always a question of reasonableness under the circumstances." Clearwater v. State Farm Mut. Auto. Ins. Co., 780 P.2d 423, 426 (Ariz. Ct. App. 1989) (citations omitted).

111. *See* Green v. J.C. Penney Auto Ins. Co., 806 F.2d 759, 764 (7th Cir. 1986) (applying Illinois law); Coleman v. Holecek, 542 F.2d 532, 537 (10th Cir. 1976) (applying Kansas law); Bostwick v. Foremost Ins. Co., 539 F. Supp. 517, 520 (D. Mont. 1982); Safeco Ins. Co. v. Ellinghouse, 725 P.2d 217, 226-27 (Mont. 1986); State Farm Fire & Cas. Co. v. Price, 684 P.2d 524, 532 (N.M. Ct. App. 1984) ("We believe that . . . failure to defend . . . may amount to bad faith, depending on the facts.").

112. Clearwater v. State Farm Mut. Auto. Ins. Co., 780 P.2d 423, 427 (Ariz. Ct. App. 1989). The court in this case stated:

> One of the major factors supporting the claim for tort damages in bad faith cases is that of deterrence. . . . In contractual relationships in which one party primarily has sought protection or security rather than profit or advantage, contract damages not only fail to provide adequate compensation but also fail to provide a substantial deterrence against breach by the party who derives a commercial benefit from the relationship.

Id. (quoting Rawlings v. Apodaca, 726 P.2d 565, 575-76 (1986)); *see also* Beck v. Farmers Ins. Exch., 701 P.2d 795, 800 (Utah 1985).

113. *See* JERRY, *supra* note 10, § 111[g][4].

114. Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 759 (N.D. 1980).

Furthermore, by refusing to either allow a tort recovery for refusal to defend or broadening the traditional view of contract damages, the court places the insurance company in a better position for breaching its contract to defend than it would be in if it undertook the defense but negligently failed to settle.[115]

As illustrated, courts have struggled with the role that the concept of good faith should play in reviewing an insurance company's wrongful refusal to defend an insured. As noted by one court:

> Because . . . "bad faith" is essentially a breach of implied fiduciary duties that arise out of the insurer's right to control the defense and settle claims against the insured, some courts view bad faith as an irrelevant concept where the insurer refuses to defend, and treat such cases as pure breach of contract. Under a contract theory, an excess verdict against the insured is simply an element of damage resulting from the insurer's breach of the duty to defend. Others view the insurer's abandonment of the defense of the insured and consequent refusal to settle as the most extreme degree of breach of the insurer's fiduciary duty. *Whether viewed as contract or tort, the overwhelming majority of courts at least agree that an insurer who incorrectly denies coverage and then refuses to settle should be in no better position than the insurer who accepts coverage but fails to meet its settlement obligations.*[116]

Many courts that apply the tort standard appear to follow an "ends-justifies-the-means" approach: a tort action allows recovery of tort damages and provides a greater deterrence against breach of the duty to defend. An insurance company that refuses to undertake the broader duty to defend should not be in a better position than the insurer that undertakes the defense but wrongly refuses to settle. The damages to the insured may be greater when the insurer refuses to defend from the outset. Also, the widespread acceptance of the tort of bad faith for both failure to pay first party claims and failure to settle third party cases may lull courts into an incomplete or cursory analysis of the contract/tort dichotomy.

To reach the laudable goal of full compensation and more adequate deterrence, courts need not abandon the traditional distinction between tort and contract actions. Absent a separate imposed-at-law duty to defend, or the assumption of some fiduciary duty, the breach of the contractual duty to defend should not generate a tort action. If the insurer refuses to undertake the contractual obligation to defend, the insurer likewise refuses to undertake the duty of good faith that may arise when the insurance company faces a

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115. Warren v. Farmers Ins. Co., 838 P.2d 620, 623-24 (Or. 1992) (criticizing Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015 (Or. 1978)).

116. Robinson v. State Farm Fire & Cas. Co., 583 So. 2d 1063, 1067 (Fla. Dist. Ct. App. 1991) (footnotes omitted) (emphasis added).

conflict of interest between itself and the insured.[117] Courts need not twist a breach of contract action into a tort action to allow for fair compensation to the insured and deter the insurer from breaching its duty to defend. A more liberal allowance of recovery of consequential damages that naturally flow from the breach and that are foreseeable at the time of the contract should grant sufficient recovery to place the insured in as good of a position as he would have been had the insurer performed its duty. Under either a contract or tort approach, the insured should be allowed to recover damages that adequately compensate for the injuries caused by the breach and that do not place the insurance company in a better position than it would be if it had defended the case.

B. *Attorneys' Fees Incurred to Enforce the Duty to Defend*

When an insurance company wrongfully refuses to defend, the abandoned insured has to hire her own attorney to defend the case or face a default judgment. To recover those defense costs, the insured may have to sue the insurance company in a declaratory judgment action or other legal proceeding. In some instances, the insurance company files a declaratory judgment action to determine its obligation to defend the insured and the insured must incur legal expenses to defend that action. When the insurance company refuses to defend, the company could reasonably foresee the insured would incur additional attorneys' fees in an action to determine the insurer's duty to defend. The question becomes whether the insured should be able to recover attorneys' fees in such an enforcement proceeding. The courts are split on this issue.[118]

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117. Granted, an argument can be made that an insurer has a good faith obligation, inherent in all contracts, to evaluate the request for defense in good faith. The same argument garnered support in cases that adopted the third-party bad faith action (failure to settle) for first-party actions (failure to pay). The logic is flawed, however, because the origins of the bad faith tort rest in the third party context where the insurer undertakes a fiduciary obligation to defend the insured in the insured's best interest but faces a conflict of interest when evaluating whether to settle. No such fiduciary obligation or conflict of interest arises when an insurer refuses to perform under the contract, either by refusing to pay a first-party claim or refusing to defend the insured against a third-party suit. The same arguments asserted here in favor of a contract approach with broader damages apply in the first party failure to pay context. *See, e.g.*, Liberty Mut. Ins. Co. v. Parkinson, 487 N.E.2d 162, 165 (Ind. Ct. App. 1985) ("Due to our development of this special contractual remedy which affords the insured a more generous measure of damages, we have found no reason to adopt bad faith as an independent tort in this state . . . ."); Spencer v. Aetna Life & Cas. Ins. Co., 611 P.2d 149, 155 (Kan. 1980) (noting the differences between failure-to-settle cases and first party cases, the court refused to recognize a separate tort of bad faith failure to pay because, among other things, no fiduciary relationship existed); Lawton v. Great Southwest Fire Ins. Co., 392 A.2d 576, 581-82 (N.H. 1978) (rejecting bad faith in first-party claims but expanding the measure of consequential damages recoverable); Beck v. Farmer's Ins. Exch., 701 P.2d 795, 800 (Utah 1985) (rejecting a bad faith tort because the obligations between the insurer and insured "are contractual rather than fiduciary").

118. A sampling of cases *denying* recovery of attorneys' fees incurred when the insured sues to enforce the contract or defends a declaratory judgment action includes: Hilde v. United

For example, in *Hilde v. United States Fire Insurance Co.*,[119] the court denied attorneys' fees in a declaratory judgment action.[120] The court examined the right of an insured to recover the costs incurred in defending a declaratory judgment action filed by the insurance company to test its obligation to defend and indemnify the insured. Although the court did not discuss the theory under which the insured sued to recover the costs and fees incurred in defending the declaratory judgment action, the Georgia Appellate Court stated solid, logical reasons for denying those requests. The court noted that this insurer had a legitimate reason to dispute coverage.[121] Absent bad faith, fraudulent intent, or "stubborn litigiousness," parties to a contract

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States Fire Ins. Co., 362 S.E.2d 69, 71-72 (Ga. Ct. App. 1987); Spruill Motors Inc. v. Universal Underwriters Ins. Co., 512 P.2d 403, 409 (Kan. 1973); Lujan v. Gonzales, 501 P.2d 673, 682-83 (N.M. Ct. App. 1972).

Some cases generally *allowing* the insured to recover attorneys' fees incurred in litigation to enforce the duty to defend include: Green v. J.C. Penney Auto Ins. Co., 806 F.2d 759, 765 (7th Cir. 1986) (applying Illinois law) ("[W]here an insurer breaches its duty to defend its insured and thereby forces the insured to bear the burden of initiating a declaratory judgment action against the insurer, the insured can recover attorneys' fees incurred from bringing the declaratory judgment action."); Beckwith Mach. Co. v. Travelers Indem. Co., 638 F. Supp. 1179, 1189-90 (W.D. Pa. 1986) (stating that although not a declaratory judgment action, the court could "find no rational reason to draw a distinction between a declaratory judgment action brought by an insured and the present one [for breach of contract] since both actions culminate from the insurer's breach of contract"); Paxton & Vierling Steel Co. v. Great Am. Ins. Co., 497 F. Supp. 573, 582 (D. Neb. 1980) (applying a Nebraska statute); Independent Sch. Dist. v. St. Paul Fire & Marine Ins. Co., 515 N.W.2d 576, 581 (Minn. 1994); S.G. v. St. Paul Fire & Marine Ins. Co., 460 N.W.2d 639, 645 (Minn. Ct. App. 1990); State Farm Fire & Cas. Co. v. Sigman, 508 N.W.2d 323, 325 (N.D. 1993); Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156, 159-61 (W. Va. 1986).

Some jurisdictions limit recovery of attorneys' fees in coverage actions to situations where the insurer refused in bad faith to defend the insured. *E.g.*, Twin City Fire Ins. Co. v. Home Indem. Co., 650 F. Supp. 785, 792-93 (E.D. Pa. 1986) (denying attorneys' fees in coverage action because the refusal to defend was not in bad faith); Kelmo Enterprises Inc. v. Commercial Union Ins. Co., 426 A.2d 680, 685 (Pa. 1981) (awarding attorneys' fees because insurer acted in bad faith); F.B. Washburn Candy Co. v. Fireman's Fund Ins. Co., 541 A.2d 771, 773-74 (Pa. Super. Ct. 1988); Farmers Ins. Exch. v. Call, 712 P.2d 231, 237-38 (Utah 1985).

In *Associated Indemnity Corp. v. Warner*, 694 P.2d 1181, 1183 (Ariz. 1985), the insurer who was successful in its declaratory judgment action sought, pursuant to a statute, to recover its attorneys' fees from its insured. The statute granted the trial court discretion to award attorneys' fees to the successful litigant in a contract action. *Id.* at 1184. The trial court refused to award the insurance company its attorneys' fees against the insured. *Id.* at 1183. The Supreme Court of Arizona affirmed, noting the "nature of the action and the relative economic position of the parties . . . ." *Id.* at 1185.

See cases discussed in Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156, 159-60 (W. Va. 1986); *see also* cases cited in BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 5.05[b] (3d ed. Supp. 1990) and Jane M. Draper, Annotation, *Insured's Right to Recover Attorneys' Fees Incurred in Declaratory Judgment Action to Determine Existence of Coverage Under Liability Policy*, 87 A.L.R.3d 429 (1978).

119. Hilde v. United States Fire Ins. Co., 362 S.E.2d 69 (Ga. Ct. App. 1987).

120. *Id.* at 72.

121. *Id.* at 71.

have a right to use the judicial system to determine their rights under the contract.[122] The court concluded that the right to seek a declaratory determination constitutes an inherent right, and therefore, refused to "punish the exercise of a right or chill its exercise by making the seeking of a declaratory judgment a potentially expensive gamble."[123] The court conceded that an exception to the rule might exist, commenting that it would be inclined to agree with the insured's claim for reimbursement "if [the] case involved an intractable and wrongful refusal to undertake a defense or a refusal to pay any claim at all."[124]

Equally valid reasons for allowing an award of attorneys' fees incurred in the declaratory judgment action to determine the duty to defend were acknowledged by the West Virginia Supreme Court in *Aetna Casualty & Surety Co. v. Pitrolo*.[125] The court recognized the split among jurisdictions concerning the recoverability of attorneys' fees incurred in a declaratory judgment action, and acknowledged that "several" jurisdictions follow the "American rule" and preclude an award of attorneys' fees.[126] A second group of jurisdictions allows a recovery of fees incurred in the declaratory judgment action only if the insurer "acted in bad faith, fraudulently . . . or was stubbornly litigious."[127]

The West Virginia Supreme Court's ruling embraced the third view. The court termed the view as the "better view," that allows the insured to recoup reasonable attorneys' fees when the declaratory judgment action concludes the insurer must defend the insured.[128] The court opted for the "better view" because it awards an insured a reasonable attorneys' fee whenever the court determines that the insurer was obligated to defend its insured.[129]

The court articulated several reasons why this approach represented the "better view." First, the court reasoned that the insured should be fully compensated for all expenses incurred as a result of the insurer's breach of its contractual obligation to defend.[130] Expenses incurred in the defense of the declaratory judgment should be reimbursed so that the insured who purchased insurance for protection "from incurring attorneys' fees and expenses arising from litigation" would receive the protection purchased.[131]

Second, the court referred to the general rules regarding an insurer's

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122. *Id.*

123. *Id.* at 72.

124. *Id.* United States Fire Insurance Company, the insurer in this case, had obtained a stay of the case against its insured when it filed the declaratory judgment action. When the court of appeals in the declaratory judgment action determined that United States Fire owed a defense and coverage under its policy, the insurance company promptly entered a defense and obtained a settlement of all the claims against its insured. *Id.* at 70-71.

125. Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156 (W. Va. 1986).

126. *Id.* at 159.

127. *Id.*

128. *Id.* at 159-60.

129. *Id.* at 160-61.

130. *Id.* at 160.

131. *Id.*

duty to defend. Because the duty to defend may be broader than the obligation to pay, and the duty to defend is tested in light of the allegations of the complaint, any question regarding the duty to defend should be determined liberally in favor of defense.[132] These principles support a liberal rule of recovery when the insurer wrongfully refuses to defend the insured.[133]

Third, the court rejected the rationale of the courts that allow attorneys' fees incurred in declaratory judgment actions only upon a finding that the insurance company acted in bad faith in denying a defense. "Whether an insurer's refusal to defend was in good or bad faith is largely irrelevant once it has been established that the insurer breached its contract with the insured."[134] Such a requirement of establishing bad faith, the court concluded, places an unfair burden on the insured who contracted to have its litigation expenses covered.[135] Requiring the insured to bear the expenses of the declaratory judgment action defeats that contractual goal.[136]

The reasons articulated by the court in *Pitrolo* justify allowing the insured to recover the attorneys' fees incurred in enforcing the insurance company's duty to defend. The traditional American rule denying attorneys' fees thwarts one of the significant purposes for which insureds purchase litigation insurance—avoidance of litigation expense.

C. *Judgment Amounts in Excess of Policy Limits*

Courts are likewise divided over whether the insured, after suffering a judgment in excess of policy limits, can recover the full judgment amount from the insurance company. Courts adhering to the strict contract approach refuse to allow such an award on the basis that the policy limits dictate the maximum amount the insurer can pay as indemnification of the insured.[137] Other courts recognize the availability of recovery for an excess judgment if the insurer refuses to defend in bad faith or demonstrates tort-like conduct.[138]

Still other courts allow the insured to recover the amount of the excess judgment if the insurer's failure to defend proximately caused the excess

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132. *Id.*
133. *Id.*
134. *Id.*
135. *Id.*
136. *Id.* at 160-61 (quoting 7C JOHN A. APPLEMAN, INSURANCE LAW AND PRACTICE § 4691, at 282-83 (Berdal ed. 1979)).
137. *E.g.*, State Farm Mut. Auto. Ins. Co. v. Paynter, 593 P.2d 948, 954-55 (Ariz. Ct. App. 1979); United Services Auto. Ass'n v. Pennington, 810 S.W.2d 777, 784 (Tex. Ct. App. 1991); *see also* JERRY, *supra* note 10, § 111[g][2].
138. Green v. J.C. Penney Auto Ins. Co., 806 F.2d 759, 762 (7th Cir. 1986) (applying Illinois law); Coleman v. Holecek, 542 F.2d 532, 537 (10th Cir. 1976) (applying Kansas law); Transport Ins. Co. v. Michigan Mut. Liab. Ins. Co., 340 F. Supp. 670, 676 (E.D. Mich. 1972), *modified as to a finding of bad faith*, 496 F.2d 265 (6th Cir. 1974); Conway v. Country Cas. Ins. Co., 442 N.E.2d 245, 249 (Ill. 1982); Lujan v. Gonzales, 501 P.2d 673, 682 (N.M. Ct. App. 1972).

judgment.[139] To prove that the insurer's conduct proximately caused the excess judgment, the insured would have to show that the case could have been resolved for less than the judgment.[140] At least one court views a judgment in excess of the policy limits as a foreseeable consequence of the breach and awards recovery on that basis.[141] Another court has allowed recovery of excess judgment amounts upon a showing of *either* bad faith or proximate cause.[142]

Some of the conflicting treatment of judgments in excess of policy limits in failure-to-defend cases stems from judicial comparisons to the failure-to-settle cause of action. The source of this confusion is a natural one. In many cases, the insurance company refuses to defend and the insured faces a judgment or settlement in excess of the policy limits.[143] Thus, the failure to defend may also result in a failure to settle the claim against the insured within policy limits.

In evaluating the damages for the breach by the insurer of two separate but intertwined obligations, courts often forget that the basis for liability is also intertwined. In *Pacific Group v. First State Insurance Co.*,[144] the court

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139. Green v. J.C. Penney Auto Ins. Co., 806 F.2d at 764; State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 88 Cal. Rptr. 246, 260 (Ct. App. 1970) ("[I]f, as an expectable result of that breach, there was a failure of reasonable settlement at a sum within the policy limit, followed by a verdict and judgment in excess of the policy limit, a fact finder could reasonably view the excess as a proximate result of the original refusal to defend."); Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1302 (Fla. Dist. Ct. App. 1977) ("[T]he insurer may be liable for an excess judgment where (1) due to the actions of the insurer, the insured suffers a default or final judgment without benefit of an attorney, and (2) the insured can prove that the final judgment would have been lower had the suit been properly defended."); Wheelways Ins. Co. v. Hodges, 872 S.W.2d 776, 780-81 (Tex. Ct. App. 1994) (The court stated that although testimony supported the finding that the insurance company's refusal to defend proximately caused the default judgment, no evidence indicated that the suit against the insured could have been resolved within policy limits. Therefore, the insured had not shown that the insurance company's conduct proximately caused the excess judgment and the insurer was not liable for the portion of the judgment that exceed policy limits.); Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 6-7 (Wis. 1993) ("[A]n excess judgment is properly included in the damages for breach of any insurer's duty to defend, if the excess judgment was a natural or proximate result of the breach.").

140. Wheelways Ins. Co. v. Hodges, 872 S.W.2d at 780 (holding that although the insured offered expert testimony that the insurer's conduct caused the entry of the default judgment, the insured could not recover the full amount of that judgment absent evidence that the claim could have been settled or resolved for an amount less than awarded).

141. Thomas v. Western World Ins. Co., 343 So. 2d at 1304.

142. United Serv. Auto. Ass'n v. Pennington, 810 S.W.2d 777, 784 (Tex. Ct. App. 1991) ("In the absence of a showing either that the claim could have been resolved for the policy limits . . . or that the insurer breached its duty of good faith and fair dealing . . . , the insured's damages generally will be limited to the policy limits . . . .").

143. *See, e.g.*, Coleman v. Holecek, 542 F.2d 532, 534-35 (10th Cir. 1976) (judgment exceeded the policy limit by more than $200,000); Clearwater v. State Farm Mut. Auto. Ins. Co., 780 P.2d 423, 425 (Ariz. Ct. App. 1989) (judgment exceeded the policy limit by $75,000); Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d at 4 (judgment exceeded the policy limit by more than $500,000).

144. Pacific Group v. First State Ins. Co., 841 F. Supp. 922 (N.D. Cal. 1993).

lumped the insurer's breach of the duty to settle with the breach of its duty to defend, without discussing the different obligations inherent in those duties. The court found that the insurer's "failure to defend, coupled with its failure to settle, rendered it liable for the entire judgment."[145]

A few courts, however, have recognized the difference between the breach of the contractual duty to defend and the breach of the good faith duty to settle appropriate cases within policy limits.[146] A good illustration of a case addressing the two claims separately is *Lujan v. Gonzales*.[147] In *Lujan*, the insured was sued for wrongful death arising out of an automobile accident.[148] The jury in the wrongful death action returned a verdict against the insured well in excess of policy limits.[149] The insured Gonzales filed a third-party complaint against his insurance carrier Allstate, which had refused to defend him and refused to participate in settlement opportunities.[150] The trial court determined that the Allstate policy provided coverage, and that Allstate had breached its duty to defend.[151] The court further found that Allstate acted in bad faith in failing to settle the wrongful death action against its insured.[152] The appellate court affirmed these findings of liability.[153]

On appeal, Allstate argued that its erroneous denial of coverage, failure to defend, and failure to settle did not constitute bad faith.[154] The court addressed Allstate's contentions while discussing the obligation to defend and the obligation to settle within the context of bad faith.[155] The court astutely noted that

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145. *Id.* at 942.

146. Coleman v. Holecek, 542 F.2d 532 (10th Cir. 1976); Transport Ins. Co. v. Michigan Mut. Liab. Ins. Co., 340 F. Supp. 670 (E.D. Mich. 1972), *modified on other grounds*, 496 F.2d 265 (6th Cir. 1974); Thomas v. Western World Ins. Co., 343 So. 2d 1298 (Fla. Dist. Ct. App. 1977); Lujan v. Gonzales, 501 P.2d 673 (N.M. Ct. App. 1972).

147. Lujan v. Gonzales, 501 P.2d 673 (N.M. Ct. App. 1972).

148. *Id.* at 675.

149. *Id.* at 683. Farmers' policy provided policy limits of $30,000, which it paid. *Id.* The Allstate policy provided $10,000 of coverage. *Id.* The jury verdict in the wrongful death case was $175,500. *Id.*

150. *Id.* at 678-79. At the time of the accident, the insured Gonzales was driving his father's pick-up truck. *Id.* at 675. His father had coverage with Farmers Insurance Group. *Id.* Farmers undertook the defense of Gonzales. *Id.* at 676-77. Allstate was notified of the accident and of the lawsuit, and was requested to defend the insured and to participate in the potential settlement. *Id.* at 678. Instead, Allstate refused to defend or discuss settlement options and denied coverage *after* the opportunity to settle had expired. *Id.*

151. *Id.* at 677.

152. *Id.* at 677-79. Allstate had asserted no coverage based on the policy exclusion that prohibited coverage for the insured driving a non-owned car that was owned by a relative who is a resident of the same household. *Id.* at 676. Allstate claimed that Gonzales resided in the same household as his father whose car he was driving at the time of the accident. *Id.* The trial court found that Gonzales was not residing in his father's home at the time of the accident. *Id.*

153. *Id.* at 677-78, 681-82.

154. *Id.* at 680.

155. *Id.* The court noted that it did not have to decide whether the obligation of good faith is "an implied covenant in the insurance contract or a tort. . . . We do recognize that such a duty exists." *Id.*

> Allstate's duty of good faith in dealing with Gonzales is not of importance in considering liability for breach of the duty to defend. This is so because Allstate is liable for its breach regardless of whether the breach was in good faith. The question of Allstate's good faith is of importance in connection with Allstate's failure to attempt to settle the claim against Gonzales. If this failure was in bad faith, Allstate may be held liable for the judgment against Gonzales in excess of its policy limit.[156]

To determine whether Allstate acted in good faith when it made no attempt to settle the claim against the insured, the court proceeded *as if* Allstate had defended the case.[157] The court took this approach because, if Allstate had defended, Gonzales would have been entitled to the benefit of Allstate's "good faith evaluation of the settlement offer."[158] Because the insured should be put in as good a position as he would have been if Allstate had fulfilled its contractual duty, the court pretended that Allstate had not breached its duty to defend.[159] The determinative question concerning Allstate's liability for the excess judgment then became the same as it would have been if Allstate had defended: "whether Allstate proceeded in good faith in making no attempt to settle."[160] The court affirmed the trial court's finding that Allstate acted in bad faith for failure to attempt to settle the claim against its insured.[161] Allstate was liable for the excess judgment against the insured[162] based on Allstate's bad faith failure to settle—not the failure to defend.[163]

Viewing the claim for reimbursement of an excess verdict as if the insurer had actually undertaken the defense, allows the insured to prove that a reasonable insurer, giving at least equal weight to the interests of the insured, would have settled the claim against the insured within the policy limits.[164] This approach seems more equitable than requiring the insured to prove that the failure to defend proximately caused the excess judgment. As one court noted, the insurance company should not

> be permitted . . . by its breach of contract, to cast upon the [insured] the

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156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.* at 681.
161. *Id.* at 681-82.
162. *Id.* at 684.
163. *Id.*; *see also* Coleman v. Holecek, 542 F.2d 532 (10th Cir. 1976) (applying Kansas law) (holding that the insurer's refusal to defend was not in bad faith, but that the insurer was nevertheless liable for the full amount of the excess judgment because it failed to institute settlement negotiations); *cf.* Rogan v. Auto-Owners Ins. Co., 832 P.2d 212, 218 (Ariz. 1991) (reversing an award for the settlement amount in excess of policy limits because the insurer, who did not defend, did not reject a settlement offer even though the insurer denied coverage in bad faith).
164. JERRY, *supra* note 10, § 112[a].

> difficult burden of proving a causal relation between the [insurer's] breach of the duty to defend and the results which are claimed to flow from it. . . . To do so would cast upon the insured not only the unpleasant but the extremely difficult burden of proof on the issue whether the [insurer's] attorneys, by superior skill and wisdom, could have produced a better result at less expense than that achieved by the [insured's] counsel.[165]

D. *Emotional Distress Damages*

If an insurance company breaches a contract marketed and purchased to provide peace of mind, disruption of the insured's peace of mind follows as logically foreseeable damages from the breach. Courts, however, take divergent positions about the recoverability for loss of the bargained-for benefit of peace of mind.

Most courts reach their decisions regarding recovery for mental distress based on whether the jurisdiction characterizes the failure to defend as a breach of contract or tort.[166] Many jurisdictions that view failure to defend as purely a breach of contract deny recovery for emotional suffering.[167] Those courts regard liability insurance as no different from any other contract for economic benefit, the breach of which can be compensated with only economic damages.[168] Some courts give only lip service to the traditional contract principle that damages recoverable for breach of contract include those damages proximately caused or naturally flowing from the breach. These courts, however, deny recovery for mental anguish caused by the insurance company's refusal to defend without regard to whether those damages naturally flow from the breach.[169] The denial of mental anguish damages for breach of contract is so rooted in tradition that recovery for such damages is denied even if the damages are reasonably foreseeable and certain.[170]

Some jurisdictions that characterize the failure to defend as breach of contract acknowledge that emotional distress damages can be recovered if the contract involves personal aspects, but the courts refuse to recognize insurance contracts as having any noneconomic, personal aspects.[171] Personal interest

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

166. *See* discussion *supra* at Part V.A.

167. *See, e.g.*, Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1021-22 (Or. 1978) (holding that emotional distress caused by pecuniary loss resulting from breach of contract was not recoverable); United Serv. Auto. Ass'n v. Pennington, 810 S.W.2d 777, 784 (Tex. Ct. App. 1991) (holding that the insured's assignee failed to prove the tort claim, so the claim for tort damages, including mental anguish, also failed).

168. *See* authorities cited *supra* note 93.

169. *See* Farris v. United States Fidelity & Guar. Co., 587 P.2d at 1016; United Serv. Auto. Ass'n v. Pennington, 810 S.W.2d at 784.

170. 3 FARNSWORTH, *supra* note 9, § 12.17, at 274.

171. In *Farris v. United States Fidelity & Guaranty Co.*, 587 P.2d 1015, 1021-22 (Or. 1978), the court rejected the insured's argument that an insurance contract involves the insured's peace of mind and that recovery should be allowed for emotional damages if the

contracts generally arise in the context of burial arrangements, transportation, and lodging.[172] Such contracts are "particularly likely to result in serious emotional disturbance."[173] At least one jurisdiction holds that a contract to build a new home qualifies as a contract tied to matters of personal concern and a breach of that contract supports recovery of mental distress.[174] Likewise, a noncommercial insurance contract should fall within this exception.

Courts characterizing the failure to defend as a tort generally allow recovery for mental anguish when the insured's evidence establishes such damage.[175] A few courts, in breach-of-contract actions, realize that damages

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insurance company fails to deliver that portion of the bargain. In refusing to allow an award of emotional damages, the court found that:

> [t]he argument does not furnish a logical basis for recovery for emotional distress because many contracts for services, materials or financial assistance, as well as insurance contracts, are similarly made for economic and financial peace of mind. . . . Many contracts are made for the purpose of financial protection and assurance. If such a contractual purpose is all that is necessary to entitle one to recovery for emotional distress resulting from breach of contract, the universal rule set forth above [that emotional distress damages are not recoverable for breach of contract] would not exist.

Id. at 1022.

The validity of this holding in *Farris* may be in question. A subsequent decision by the Oregon Court of Appeals allowed recovery for emotional distress in a first party claim against an insurance company for refusing to authorize surgery. McKenzie v. Pacific Health & Life Ins. Co., 847 P.2d 879 (Or. Ct. App. 1993), *cert. dismissed*, 869 P.2d 859 (Or. 1994). In *McKenzie*, the insured's claim for emotional distress was supported by physical damages that resulted from the insurer's breach. *Id.* at 881-82. The *McKenzie* decision may therefore be distinguished from *Farris*.

172. *See* 5 CORBIN, *supra* note 9, § 1076 and cases cited therein.

173. 3 FARNSWORTH, *supra* note 9, § 12.17, at 275.

174. B & M Homes, Inc. v. Hogan, 376 So. 2d 667, 671-73 (Ala. 1979); *see also* Liberty Homes, Inc. v. Epperson, 581 So. 2d 449, 453-54 (Ala. 1991) (upholding the award of damages for mental distress in a breach of contract action); Walker Builders, Inc. v. Lykens, 628 So. 2d 923, 924 (Ala. Civ. App. 1993) (affirming an award by the jury for mental anguish in a breach of contract suit).

For years, the Alabama courts adhered to the principle that an insured cannot recover for "personal injury, inconvenience, annoyance or mental anguish and suffering in an action for breach of a contract of insurance." Vincent v. Blue Cross-Blue Shield, Inc., 373 So. 2d 1054, 1056 (Ala. 1979); *see also* United Serv. Auto. Ass'n v. Wade, 544 So. 2d 906, 913 (Ala. 1989); Stead v. Blue Cross-Blue Shield, Inc., 346 So. 2d 1140, 1143 (Ala. 1977). Without even acknowledging this prior line of cases, however, the Alabama Supreme Court affirmed an award of approximately $23,000 for mental anguish in a first party insurance breach of contract claim. Independent Fire Ins. Co. v. Lunsford, 621 So. 2d 977, 979 (Ala. 1993). The court rendered judgment for the insurer on the bad faith claim. *Id.* at 978-79. In a separate opinion by Justice Maddox, he notes that the decision overrules *Stead v. Blue Cross-Blue Shield, Inc.*, 346 So. 2d 1140, 1143 (Ala. 1977). *Id.* at 981 (Maddox, J., concurring in part; dissenting in part). Justice Maddox advocates restricting the cause of action for failure to honor an insurance contract to a breach of contract action but expanding the contractual damages available. *Id.*

175. *See, e.g.*, Tan Jay Int'l, Ltd. v. Canadian Indem. Co., 243 Cal. Rptr. 907, 912-13 (Ct. App. 1988); State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 88 Cal. Rptr. 246, 259

other than purely economic ones flow from the breach of an insurance contract.[176] These courts allow the insured to recover for noneconomic damages that proximately flow from the insurance company's breach of the insurance contract without creating a separate tort action.[177]

In *Tan Jay International, Ltd. v. Canadian Indemnity Co.*,[178] the court recognized the appropriateness of recovery of emotional distress damages when an insurance company wrongfully refuses to defend. The court noted that an insured purchases liability insurance to protect himself from unexpected losses,[179] and the emotional suffering that may accompany such losses.[180] Thus, peace of mind and security constitute factors in purchasing insurance coverage.[181] Therefore, if an insurance company tortiously destroys the peace of mind for which the insured bargained, the insured may recover damages for mental anguish.[182]

Evidence of the insured's emotional injuries in *Tan Jay* included his abandonment by the insurance company to face a multimillion dollar lawsuit, loss of reputation, concern over losing his business, and, the erosion of his peace of mind.[183] The court concluded that proof of emotional damages "does not require proof of bankruptcy, physical illness or injury, nor

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(Ct. App. 1970); Palmer v. Pacific Indem. Co., 254 N.W.2d 52, 56 (Mich. Ct. App. 1977) (holding that mental distress foreseeable from breach of the duty to defend by refusing to appeal and therefore proper to submit to a jury); Safeco Ins. Co. v. Ellinghouse, 725 P.2d 217, 226, 228 (Mont. 1986) (holding jury verdict of $200,000 for emotional distress and $5 million in punitive damages remitted to total award of $1 million); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 761-62 (N.D. 1980) (holding emotional distress damages recoverable for refusal to defend, but they were not proven to the satisfaction of the jury).

176. *See* cases cited *supra* note 86.

177. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 88 Cal. Rptr. at 258-59.

178. Tan Jay Int'l, Ltd. v. Canadian Indem. Co., 243 Cal. Rptr. 907 (Ct. App. 1988).

179. *Id.* at 912. The comprehensive business liability policy issued to Tan Jay included Nygard, the principal owner and chairman of the board, as a named insured. *Id.* The negligence action against Tan Jay and Nygard resulted in a verdict of $2.1 million. *Id.* at 909. Collection efforts against Tan Jay harmed its business reputation, and if the judgment had been executed, the company would have been destroyed. *Id.* Tan Jay and Nygard sued for declaratory relief, bad faith, and emotional distress. *Id.* The jury rendered a verdict in favor of the insured for compensatory damages in excess of $5 million and $35 million in punitives. *Id.* at 908. The items of compensatory damages included the $2.1 million verdict, approximately $150,000 in attorneys' fees, damage to Tan Jay's business reputation, and the insured Nygard's emotional damages. *Id.* at 909.

The trial court found that damages were excessive and granted a new trial on the issue of damages. *Id.* at 910. The trial court also granted judgment notwithstanding the verdict as to Nygard's claim for mental distress. *Id.*

On appeal, the California Court of Appeals agreed that the damages awarded were excessive and that a new trial was warranted on the issue of damages. *Id.* at 911. The Court, however, reversed the judgment against Nygard. *Id.* at 913.

180. *Id.* at 912.

181. *Id.*

182. *Id.* (quoting Truestone, Inc. v. Travelers Ins. Co., 127 Cal. Rptr. 386 (Ct. App. 1976)).

183. *Id.* at 913.

courtroom demonstrations of the destruction of personal peace of mind or well being."[184]

Although the insured in *Tan Jay* presented significant evidence of emotional distress, his recovery for those damages hinged on the fortuity of where the suit was brought. Even under a contract approach, full recovery for emotional damages should not be denied when insurance companies are aware that their decisions to deny a defense will result in mental anguish.[185] Insurance companies market their products with direct plays to the public's desire for peace of mind and protection.[186] Insurance companies focus on the role that the desire for solicitude plays in the purchase of insurance contracts and direct their marketing efforts toward that concern. They should be ready to compensate their policy holders for resulting mental distress when the insurers fail to deliver the promised benefit. Courts should recognize that peace of mind motivates the insured to enter the insurance contract and a breach of that contract causes mental anguish. Recovery of these damages should be allowed in a contract action as an acknowledgment that insurance contracts fall within that special category of contracts so coupled with matters of mental concern that the breach will necessarily result in mental anguish.

E. *Punitive Damages*

The availability of punitive damages for failure to defend also follows, to some extent, the contract or tort dichotomy.[187] A growing number of jurisdictions allow punitive damages when there is a breach of an insurance

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184. *Id.*

185. *See* Campbell v. State Farm Mut. Auto. Ins. Co., 840 P.2d 130, 133, 140 (Utah Ct. App. 1992) (stating that the eventual payment of an excess judgment does not compensate the insured for the emotional injury caused when an insurer refused to settle; case involved an insurance company claims representative who testified that he knew the insureds would suffer extreme emotional distress if the insurance company rejected settlement).

186. *See supra* note 13.

187. The courts in the following cases denied recovery of punitive damages because of adherence to the general rule that punitive damages cannot be recovered for breach of contract:

Kocse v. Liberty Mut. Ins. Co., 377 A.2d 1234, 1236-38 (N.J. Super. Ct. App. Div. 1977); Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1022-23 (Or. 1978).

Other courts have recognized the appropriateness of punitive damages when the refusal to defend was in bad faith or accompanied by other tortious conduct:

Tibbs v. Great Am. Ins. Co., 755 F.2d 1370, 1375 (9th Cir. 1985) (holding that, in California, punitive damages cannot be recovered for breach of contract, but are available when the insurer's breach of the covenant of good faith is accompanied by fraud, malice, or oppression); *see also* Pacific Group v. First State Ins. Co., 841 F. Supp. 922, 938-40 (N.D. Cal. 1993) (vacating the jury's award of $21 million in punitive damages because they were not supported by evidence of any intent by the insurer to injure, vex, or consciously disregard the insured's rights); Twin City Fire Ins. Co. v. Home Indem. Co., 650 F. Supp. 785, 793 (E.D. Penn. 1986) (holding punitive damages not recoverable because the insurer did not refuse to defend in bad faith); Bostwick v. Foremost Ins. Co., 539 F. Supp. 517, 520 (D. Mont. 1982) (holding punitive damages recoverable in an action for bad faith failure to defend); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 766 (N.D. 1980) (affirming a punitive damage award of $50,000 for tortious failure to defend).

contract.[188] When courts allow punitive damages stemming from the breach of an insurance contract, the insured generally must prove tortious conduct by the insurer, such as willful or wanton conduct, malice, or intent to injure.[189]

Problems inherent in allowance of punitive damages are well documented[190] and beyond the scope of this Article. Any award of punitive damages should bear some reasonable relationship to the wealth of the defendant. The passion of the jury should not dictate whether punitives are awarded; nor should the award be unreasonably oppressive.[191]

Punitive damages are designed to accomplish two purposes: to punish the wrongdoer and to deter similar conduct.[192] The same deterrent effect may be accomplished by broadening the scope of compensatory damages awardable for wrongful refusal to defend. Broader compensatory damages would not have the "over-deterrent" effect of an unlimited award of punitive damages. "To the extent the availability of tort remedies 'overdeters' a large number of insurers, the costs incurred by insurers rise, which translates into higher premiums for all insureds."[193] Maintaining the general prohibition on punitive damages in contract actions while expanding the range of recoverable damages for wrongful refusal to defend would meet the goals of adequate compensation and deterrence without the over-deterrent effect punitive damages can create.

VI. SUGGESTED RESOLUTION

Whether an insured is fully compensated for an insurance company's

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188. See cases discussed in Oliver B. Cannon & Son, Inc. v. Fidelity & Cas. Co., 484 F. Supp. 1375, 1387 & n.40 (D. Del. 1980).

189. *Id.* at 1387-88; *see also, e.g.*, Tibbs v. Great Am. Ins. Co., 755 F.2d at 1375; Pacific Group v. First State Ins. Co., 841 F. Supp. at 938-40; Twin City Fire Ins. Co. v. Home Indem. Co., 650 F. Supp. at 793; Smith v. American Family Mut. Ins. Co., 294 N.W.2d at 766.

190. Cases that have sparked debate about punitive damages include, for example: TXO Prod. Corp. v. Alliance Resources Corp., 509 U.S. 443 (1993); Pacific Mut. Ins. Co. v. Haslip, 499 U.S. 1 (1991); Browning-Ferris Indus. of Vt., Inc. v. Kelco Disposal, Inc., 492 U.S. 257 (1989); Bankers Life & Cas. Co. v. Crenshaw, 486 U.S. 71 (1988).

A small sampling of commentary about punitive damages includes the following: Victor E. Schwartz & Mark A. Behrens, *Punitive Damages Reform—State Legislatures Can and Should Meet the Challenge Issued by the Supreme Court of the United States in* Haslip, 42 AM. U. L. REV. 1365 (1993); James Breslo, Comment, *Taking the Punitive Damages Windfall Away from the Plaintiff: An Analysis*, 86 NW. U. L. REV. 1130 (1992); Nancy G. Dragutsky, Note, *Walking the Invisible Line of Punitive Damages:* TXO Productions Corp. v. Alliance Resources Corp., 21 PEPP. L. REV. 909 (1994); Leslie E. John, Comment, *Formulating Standards for Awards of Punitive Damages in the Borderland of Contract and Tort*, 74 CAL. L. REV. 2033 (1986); Michael J. Pepek, Casenote, TXO v. Alliance*: Due Process Limits and Introducing a Defendant's Wealth When Determining Punitive Damages Awards*, 25 PAC. L.J. 1191 (1994).

191. Tibbs v. Great Am. Ins. Co., 755 F.2d 1370, 1375 (9th Cir. 1985); Safeco v. Ellinghouse, 725 P.2d 217, 226-27 (Mont. 1986).

192. 1 LINDA L. SCHLUETER & KENNETH R. REDDEN, PUNITIVE DAMAGES § 2.2(A)(1) (2d ed. 1989).

193. JERRY, *supra* note 10, § 111[g][4].

wrongful refusal to defend should not depend upon the fortuity of the jurisdiction. Some legal academics have suggested that the growing recognition of the tort of bad faith may soon erase the inequities of recoveries.[194] Courts, however, need not adopt a bad faith tort action to remedy the insured in a refusal to defend case.[195] Adopting the bad faith approach ignores the basis for imposition of that liability—the undertaking of fiduciary obligations—that is noticeably missing when the insurer refuses to undertake its duty to defend. Bad faith claims create as many problems as they solve. The very broad damages available for a tort cause of action may cause some insurers to defend cases for which coverage clearly does not exist.[196] The often unbridled award of punitive damages illustrates just one of those problems.

Opening Pandora's box by creating yet another bad faith tort presents a questionable solution for the dilemma of the appropriate remedy for failure to defend. The insured can be adequately compensated by allowing recovery for all damages caused by the insurer's breach of its duty to defend. This approach will require the lifting of traditional constraints imposed by a false dichotomy of contract versus tort damages.[197]

The traditional measure of damages for breach of contract, under the often-quoted rule of *Hadley v. Baxendale*,[198] are those damages that arise naturally from the breach or those damages that were within the contemplation of the parties when the contract was made.[199] In view of the marketing approach taken by insurers—playing on an insured's desire for security—emotional damages logically fit within this traditional measure of damages because they naturally flow from the breach and they were within the contemplation of the parties when the liability insurance policy was purchased.[200] The general rule prohibiting the recovery of emotional distress damages for breach of contract recognizes an exception for those contracts so closely coupled to matters of mental concern.[201] Litigation insurance contracts should fall within that exception.

Some courts refuse to recognize a bad faith cause of action for breach of a first party insurance contract, but allow full recovery of consequential

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194. WILLIAM M. SHERNOFF ET AL., INSURANCE BAD FAITH LITIGATION § 3.15[1] (1994).

195. *See* Freemon, *supra* note 53, at 69 (providing support for broadening recovery for breach of an insurance contract and limiting the use of bad faith actions and punitive damages).

196. JERRY, *supra* note 10, § 111[g][4].

197. As the court noted in *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 799 (Utah 1985), a first party insurance case:

> [T]he practical end of providing a strong incentive for insurers to fulfill their contractual obligations can be accomplished as well through a contract cause of action, without the analytical straining necessitated by the tort approach and with far less potential for unforeseen consequences to the law of contracts.

198. Hadley v. Baxendale, 9 Exch. 341, 156 Eng. Rep. 145 (1854).

199. 5 CORBIN, *supra* note 9, § 1007. See also the discussion of the *Hadley v. Baxendale* rule in the context of breach of contract cases in Freemon, *supra* note 53, at 109-10, 113-15.

200. *See generally* Freemon, *supra* note 53.

201. *See supra* notes 169-75 and accompanying text.

damages, including emotional distress.[202] This approach should also be followed when an insurance company refuses to defend an insured. No reason justifies allowing recovery for emotional distress damages when an insurer refuses to settle or pay an insured's claim while denying such recovery when the insurer refused to defend. Abandoning an insured to face a multi-million dollar lawsuit may result in greater emotional distress for a longer period than would result from a failure to pay a claim.[203]

Other damages that logically flow from the breach of the litigation insurance portion of the policy include the attorneys' fees incurred in defending or prosecuting a declaratory judgment action to enforce the insurance company's obligation to defend. The insured contracted to have the insurance company meet the insured's litigation expenses. Requiring the insured to defend herself in the liability case and incur legal expenses to enforce an obligation to defend robs the insured twice of the goal of litigation insurance.[204] Costs of enforcing the benefit of litigation insurance should be recoverable regardless of the insurance company's good or bad faith in breaching its duty to defend. The insured incurs these expenses regardless of the company's good faith.

Whether an insured abandoned by the insurance company can recover for a judgment against him in excess of the policy limits should be determined by applying the same standards used in evaluating an insurer's liability for failure to settle. Jurisdictions differ as to whether the standard for liability for refusal to settle a case is one of negligence or bad faith.[205] The court should analyze the case as if the company defended the insured and should award the excess judgment amount if the insurer violated the acceptable standard of conduct.[206] This approach places the nonbreaching party in the same position in which he would have been had the breach not occurred. If the insurance company defended the insured, but refused to settle and an excess verdict was rendered, the insured could argue that a reasonable insurer, giving appropriate deference to the interests of the insured, would have settled the case. The abandoned insured should have the same argument available and should not have to bear the difficult burden of proving that the refusal to defend proximately caused the excess verdict.[207]

Unlike damages for an excess judgment, emotional distress, and attorneys' fees, punitive damages do not compensate the insured for conse-

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202. *See, e.g.*, Liberty Mut. Ins. Co. v. Parkinson, 487 N.E.2d 162, 165 (Ind. Ct. App. 1985); Beck v. Farmers Ins. Exch., 701 P.2d 795, 801 (Utah 1985). For additional discussion supporting imposition of consequential and extra-contractual damages for breach of an insurance contract, see Freemon, *supra* note 53 and Barry Perlstein, *Crossing the Contract-Tort Boundary: An Economic Argument for the Imposition of Extracompensatory Damages for Opportunistic Breach of Contract*, 58 BROOK. L. REV. 877 (1992).

203. Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 758 (N.D. 1980).

204. Aetna Cas. & Sur. Co. v. Pitrolo, 342 S.E.2d 156, 159 (W. Va. 1986).

205. *See* 7C APPLEMAN & APPLEMAN, *supra* note 22, § 4712; JERRY, *supra* note 10, § 112.

206. *See* Lujan v. Gonzales, 501 P.2d 673 (N.M. Ct. App. 1972).

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

quences of the breach of the duty to defend. The well-recognized purpose of punitive damages is to punish the defendant and deter similar conduct. In suits for wrongful refusal to defend, deterrence can be achieved by broadening the damages recoverable so the insured is fully compensated for the insurer's breach. If full recovery of foreseeable damages is allowed, the need for punitive damages as a deterrent to insurer misconduct should recede.

Several courts have recognized that policy limits do not measure the appropriate recovery for breach of an insurance policy.[208] If the insurer performs its obligation under the policy, the amount of the policy limits controls the amount an insurer will be liable to pay a third party because of the insured's liability. Those limits do not and should not control the amount the insurer pays to the insured as damages for breach of contract by the insurance company. Allowing insureds full recovery for damages sustained when an insurance company wrongfully refuses to defend will provide adequate compensation and deter similar conduct. The breaching insurance company would no longer find itself better off for refusing to defend the insured than it would be if it undertook the defense but breached its good faith obligation to settle within policy limits. Allowing full recovery thus provides the insured with the benefits of the litigation insurance she purchased and deters the insurance company from wrongfully refusing to defend without straining the theoretical foundations of tort law.

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208. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 88 Cal. Rptr. 246, 259 (Ct. App. 1970) ("[D]amages for breach of the duty to defend are not inexorably imprisoned within the policy limit but are measured by the consequences proximately caused by the breach."); Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1302 (Fla. Dist. Ct. App. 1977) ("There is an important difference between the liability of an insurer who performs its obligations and that of an insurer who breaches its contract. The policy limits restrict only the amount the insurer may have to pay in the performance of the contract as compensation to a third person for personal injuries caused by the insured; they do not restrict the damages recoverable by the insured for a breach of contract by the insured.") (quoting Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198 (Cal. 1958)); Liberty Mut. Ins. Co. v. Parkinson, 487 N.E.2d 162, 165 (Ind. Ct. App. 1985) (first party case) ("Although [the insurer] may have settled with [the insured] for all benefits due under the policy, [the insured] did not receive all she was due under the contract." The insured was entitled to compensation for the insurer's breach of the implied covenant of good faith.); Beck v. Farmers Ins. Exch., 701 P.2d 795, 801 (Utah 1985) (first party action) ("[T]here is no reason to limit damages recoverable for breach of a duty to investigate, bargain, and settle claims in good faith to the amount specified in the insurance policy. Nothing inherent in the contract law approach mandates this narrow definition of recoverable damages.") (note and citation omitted); *see also* Freemon, *supra* note 53 (discussing the trend toward broader recognition of consequential damages for breach of an insurance contract in failure-to-pay and failure-to-settle cases).