

Reimbursing Insurers' Defense Costs: Restitution and Mixed Actions

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I. INTRODUCTION

The pejorative “Indian giver” describes a person who, having given a gift to another, takes it back or demands its return. This childhood insult arguably has surfaced in the law of liability insurance. A liability insurer that provides its insured with a defense to a lawsuit, but that later seeks to recover from the insured the costs associated with the defense of uncovered claims, might be described by the insured or by an insensitive court as an Indian giver. Having promised to defend its insured even against suits that are “groundless, false or fraudulent,”¹ an insurer that later seeks the reimbursement of its costs associated with the defense of uncovered counts or claims is sure to be viewed as renegeing on the bargain it struck with its insured.² The insurer is effectively taking back

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1. 1 SUSAN J. MILLER & PHILIP LEFEBVRE, MILLER'S STANDARD INSURANCE POLICIES ANNOTATED 214 (1995) (homeowners policy form HO 00 03 04 91); *see also* Redevelopment Auth. of City of Philadelphia v. Insurance Co. of N. Am., 675 A.2d 1256, 1256 (Pa. Super. Ct. 1996) (“In a typical liability policy, the insurer agrees to defend the insured against any suits arising under the policy, even if a suit is groundless, false or fraudulent.”), *appeal denied*, 689 A.2d 235 (Pa. 1997).

2. *See* Brent E. Johnson, *A Policyholder's Perspective: A Reply to Richard Giller's Article "Insurer's Right to Seek Reimbursement of Defense Costs: A National Perspective,"* 17 INS. LITIG. REP. 252, 254 (1995).

that which it promised to provide.

Liability insurers' legal entitlement to recover from insureds their costs attributable to the defense of uncovered claims, though hardly a new issue,³ merits special and renewed attention in light of the Supreme Court of California's 1997 decision, *Buss v. Superior Court*.⁴ Relying on the law of restitution, the *Buss* court held that insurers may recover from insureds those defense costs attributable to claims that are not even potentially covered under their policies.⁵ The effect of *Buss* will likely extend well beyond California; the decision has potentially far-reaching consequences for both insurance companies and insureds.⁶ This Article explores those consequences, ultimately concluding that insurers have a right to restitution depending upon the facts of the particular case.

Part II of this Article discusses and explains liability insurers' duty to defend their insureds against claims or suits by third-parties, including reservation of rights defenses and defenses provided pursuant to non-waiver agreements. This Article goes far beyond California law but, because insurers' right to reimbursement owes its development to the courts of that state, Part III studies California courts' path to *Buss* and the California Supreme Court's decision in that case. Part III also discusses other jurisdictions' treatment of many of the same issues. Part IV analyzes the legal foundations of liability insurers' right to reimbursement of defense costs attributable to uncovered claims or suits and examines criticisms of that right. That analysis includes a discussion of restitution and its application in the liability insurance context.

3. Insurers began focusing on the possible recovery of defense costs following two California appellate decisions in the early 1980s. See *Safeco Title Ins. Co. v. Moskopoulos*, 172 Cal. Rptr. 248, 250-51 (Ct. App. 1981) (insurer's reservation of rights letter reserved right to seek reimbursement of defense costs; right to reimbursement apparently assumed); *Western Employers Ins. Co. v. Arciero & Sons, Inc.*, 194 Cal. Rptr. 688, 688-89 (Ct. App. 1983) (affirming insurer's judgment against insured, including restitution for defending uncovered suit).

4. 939 P.2d 766 (Cal. 1997).

5. See *id.* at 768-69, 775-78.

6. See Michael J. Brady, *The Insurer's Right to Reimbursement: The Forgotten Remedy Rediscovered*, FOR THE DEF., Dec. 1997, at 29, 30 (stating that the *Buss* decision "may have nationwide importance"); Alan S. Rutkin, *Finding the Limits of the Defense Universe*, BEST'S REV. (PROP./CAS. ED.), Nov. 1997, at 131, 131 (stating that the principles and logic of the *Buss* decision "will apply in many jurisdictions besides California"); Andrew M. Reidy & Robert L. Carter, Jr., *Calif. Insurer Wins Right to Regain Defense Cost*, NAT'L L.J., Sept. 8, 1997, at C4, C4 (arguing that *Buss* "is likely to be far-reaching"); see also Dorn G. Bishop, *Turning a Lemon Into Lemonade: Insurance Carrier's Stratagem in Buss Prompts Supreme Court to Revisit Defense Cost Allocation Issues*, MEALEY'S LITIG. REP.: INS. No. 11 (Nov. 12, 1996), at 21, 21 (discussing intermediate appellate court's decision).

II. INSURERS' DUTY TO DEFEND

A liability insurer is contractually bound to indemnify its insured in the event the insured is held liable to a third-party for bodily injury or property damage attributable to a covered "occurrence."⁷ An insurer also has a contractual duty to defend its insured against lawsuits by third-parties alleging liability within the coverage afforded by the policy.⁸ The liability coverage in a standard homeowners policy provides that the insurer will "[p]rovide a defense at [the insurer's] expense by counsel of [the insurer's] choice, even if the suit is groundless, false or fraudulent."⁹ A standard commercial general liability ("CGL") policy provides that the insurer "will have the right and duty to defend any 'suit' seeking [specified] damages."¹⁰

An insurer's duty to defend its insured against claims or suits is separate and distinct from its duty to indemnify its insured for a covered loss or judgment.¹¹ An insurer has a right and duty¹² to defend its insured whenever the insured is sued for conduct that is even arguably or potentially covered under its policy.¹³ The insured bears the initial

7. "Occurrence," when used in the liability insurance context, is a term of art. Standard commercial general liability ("CGL") policies define an "occurrence" as "an accident, including continuous or repeated exposure to substantially the same general harmful conditions." 1 MILLER & LEFEBVRE, *supra* note 1, at 419.

8. See ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 729 (2d ed. 1996).

9. 1 MILLER & LEFEBVRE, *supra* note 1, at 214.

10. *Id.* at 409 (form policy CG 00 01 10 93).

11. See *Chi of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1115 (Alaska 1993); *Mutual Ins. Co. v. American Cas. Co.*, 938 P.2d 71, 75 n.7 (Ariz. Ct. App. 1996); *TerraMatrix, Inc. v. United States Fire Ins. Co.*, 939 P.2d 483, 486 (Colo. Ct. App. 1996); *Allstate Ins. Co. v. RJT Enters., Inc.*, 692 So. 2d 142, 144 (Fla. 1997); *Franklin v. Western Nat'l Mut. Ins. Co.*, 574 N.W.2d 405, 406 (Minn. 1998); *Allied Mut. Ins. Co. v. State Farm Mut. Auto. Ins. Co.*, 502 N.W.2d 484, 487 (Neb. 1993); *Hanneman v. Continental W. Ins. Co.*, 575 N.W.2d 445, 453 (N.D. 1998); *General Accident Ins. Co. of Am. v. Allen*, 692 A.2d 1089, 1095 (Pa. 1997); *Drexel Chem. Co. v. Bituminous Ins. Co.*, 933 S.W.2d 471, 480 (Tenn. Ct. App. 1996); *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 821-22 (Tex. 1997).

12. For recent discussions of the distinctions between an insurer's right to defend its insured and its duty to do so, see *Sherwood Brands, Inc. v. Hartford Accident & Indemnity Co.*, 698 A.2d 1078, 1083-84 (Md. 1997), and *Moeller v. American Guarantee & Liability Insurance Co.*, 707 So. 2d 1062, 1068-70 (Miss. 1996).

13. See *Madden v. Continental Cas. Co.*, 922 S.W.2d 731, 734 (Ark. Ct. App. 1996); *Buss v. Superior Court*, 939 P.2d 766, 773 (Cal. 1997); *Constitution Assocs. v. New Hampshire Ins. Co.*, 930 P.2d 556, 563 (Colo. 1996); *Shunn Constr., Inc. v. Royal Ins. Co. of Am.*, 897 P.2d 89, 90 (Idaho 1995); *Lapham-Hickey Steel Corp. v. Protection Mut. Ins. Co.*, 655 N.E.2d 842, 847 (Ill. 1995); *Maine State Academy of Hair Design*,

burden of establishing that the plaintiff's allegations are within coverage.¹⁴ The burden then shifts to the insurer to establish that the facts alleged fall within an applicable policy exclusion.¹⁵

As with all contractual duties, an insurer's duty to defend has its boundaries.¹⁶ The insurer's duty to defend is linked to coverage under its policy;¹⁷ an insurer's promise to defend its insured against even groundless, false or fraudulent suits does not affect this basic principle. An insurer's contractual obligation to defend baseless, meritless or specious claims does not mean that it is bound to defend claims that its policy does not cover.

Because a liability insurer is obligated to defend actions only of the nature and kind its policy covers,¹⁸ it is necessary to have standards or measures by which an insurer's duty may be determined in any given case. Courts generally take two approaches when determining if an insurer has a duty to defend. The majority approach may be described as the "eight corners rule."¹⁹ Under this approach, an insurer's duty to

Inc. v. Commercial Union Ins. Co., 699 A.2d 1153, 1156-58 (Me. 1997); Doe v. Liberty Mut. Ins. Co., 667 N.E.2d 1149, 1151 (Mass. 1996); Allstate Ins. Co. v. Fick, 572 N.W.2d 265, 267 (Mich. Ct. App. 1997); Ross v. Briggs & Morgan, 540 N.W.2d 843, 847 (Minn. 1995); Bonner v. Automobile Club Inter-Ins. Exch., 899 S.W.2d 925, 929 (Mo. Ct. App. 1995); Roman Mosaic & Tile Co. v. Aetna Cas. & Sur. Co., 704 A.2d 665, 669 (Pa. Super. Ct. 1997); City of Burlington v. National Union Fire Ins. Co., 655 A.2d 719, 721 (Vt. 1994).

14. See JERRY, *supra* note 8, at 729.

15. See *id.*

16. See *id.* at 733; see also Aerojet-General Corp. v. Transport Indem. Co., 948 P.2d 909, 921 (Cal. 1997) (stating that insurer's duty to defend "is not unlimited").

17. No matter how broadly construed an insurer's duty to defend might be, an insurer has no duty to defend when there is no potential for coverage under any theory. See, e.g., La Jolla Beach & Tennis Club, Inc. v. Industrial Indem. Co., 884 P.2d 1048, 1057 (Cal. 1994) (quoting Gray v. Zurich Ins. Co., 419 P.2d 168, 176 (Cal. 1966)); Continental Cas. Co. v. Brady, 907 P.2d 807, 810 (Idaho 1995); United Servs. Auto. Ass'n v. Caplin, 656 N.E.2d 1159, 1162 (Ind. Ct. App. 1995); MGM, Inc. v. Liberty Mut. Ins. Co., 855 P.2d 77, 79-80 (Kan. 1993); Thompson v. West Am. Ins. Co., 839 S.W.2d 579, 581 (Ky. Ct. App. 1992); Insured Titles, Inc. v. McDonald, 911 P.2d 209, 212 (Mont. 1996); Frontier Ins. Co. v. State, 662 N.E.2d 251, 253 (N.Y. 1995); Farmers Tex. County Mut. Ins. Co. v. Griffin, 955 S.W.2d 81, 84 (Tex. 1997).

18. See Waller v. Truck Ins. Exch., 900 P.2d 619, 628 (Cal. 1995); see also Universal Underwriters Ins. Co. v. Travelers Ins. Co., 669 A.2d 45, 47 (Del. 1995) (observing that duty to defend "is controlled by the terms of the policy").

19. See, e.g., Cheverly Terrace Partnership v. Ticor Title Ins. Co., 642 A.2d 285, 287 (Md. Ct. Spec. App. 1994); Britamco Underwriters, Inc. v. Grzeskiewicz, 639 A.2d 1208, 1210 (Pa. Super. Ct.), *appeal discontinued*, 647 A.2d 895 (Pa. 1994); National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc., 939 S.W.2d 139, 141 (Tex. 1997).

The eight corners rule has other names. Some courts prefer the "complaint allegation rule." See, e.g., John Deere Ins. Co. v. Truckin' U.S.A., 122 F.3d 270, 272 (5th Cir. 1997) (discussing Texas law); Pancakes of Haw., Inc. v. Pomare Properties Corp., 944 P.2d 83, 88 (Haw. Ct. App. 1997). Others refer to the "exclusive pleading" rule. See, e.g., Mount Vernon Fire Ins. Co. v. Scottsdale Ins. Co., 638 A.2d 1196, 1201 n.1 (Md.

defend is determined by comparing the complaint or petition with the policy.²⁰ If the facts alleged in the complaint or petition would give rise to liability under the policy if proven, the insurer must defend the insured.²¹

The eight corners rule is easy to apply. The simplicity of the eight corners rule makes it appealing to insurers and courts alike. The rule is economically advantageous for insurers, because it allows them to avoid the cost of investigating plaintiffs' claims to determine their potential defense obligations. But the eight corners rule is beset with problems that outweigh all of its claimed advantages. Most fundamentally, the

1994).

20. See, e.g., *American States Ins. Co. v. Martin*, 662 So. 2d 245, 247 (Ala. 1995); *Tri-State Ins. Co. v. Sing*, 850 S.W.2d 6, 7 (Ark. Ct. App. 1993); *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991); *Flint v. Universal Mach. Co.*, 679 A.2d 929, 934 (Conn. 1996); *Charles E. Brohawn & Bros., Inc. v. Employers Commercial Union Ins. Co.*, 409 A.2d 1055, 1058 (Del. 1979); *American Continental Ins. Co. v. Pooya*, 666 A.2d 1193, 1197 (D.C. 1995); *Sunshine Birds & Supplies, Inc. v. United States Fidelity & Guar. Co.*, 696 So. 2d 907, 909-910 (Fla. Dist. Ct. App. 1997); *Hawaiian Holiday Macadamia Nut Co. v. Industrial Indem. Co.*, 872 P.2d 230, 233 (Haw. 1994); *City of Idaho Falls v. Home Indem. Co.*, 888 P.2d 383, 387 (Idaho 1995); *American States Ins. Co. v. Koloms*, 687 N.E.2d 72, 75 (Ill. 1997); *Ottumwa Hous. Auth. v. State Farm Fire & Cas. Co.*, 495 N.W.2d 723, 726 (Iowa 1993); *James Graham Brown Found., Inc. v. St. Paul Fire & Marine Ins. Co.*, 814 S.W.2d 273, 279 (Ky. 1991); *Steptore v. Masco Constr. Co.*, 643 So. 2d 1213, 1218 (La. 1994); *Northern Sec. Ins. Co. v. Dolley*, 669 A.2d 1320, 1322-23 (Me. 1996); *Town of Ayer v. Imperial Cas. & Indem. Co.*, 634 N.E.2d 571, 572 (Mass. 1994); *Delta Pride Catfish, Inc. v. Home Ins. Co.*, 697 So. 2d 400, 403 (Miss. 1997); *Graber v. State Farm Fire & Cas. Co.*, 797 P.2d 214, 217 (Mont. 1990); *Green Mountain Ins. Co. v. Foreman*, 641 A.2d 230, 232 (N.H. 1994); *Lopez v. New Mexico Pub. Sch. Ins. Auth.*, 870 P.2d 745, 747 (N.M. 1994); *Royal Ins. Co. of Am. v. Cato Corp.*, 481 S.E.2d 383, 386 (N.C. Ct. App. 1997); *Nodak Mut. Ins. Co. v. Heim*, 559 N.W. 2d 846, 849 (N.D. 1997); *Sanderson v. Ohio Edison Co.*, 635 N.E.2d 19, 23 (Ohio 1994); *Ledford v. Gutoski*, 877 P.2d 80, 82 (Or. 1994); *General Accident Ins. Co. of Am. v. Allen*, 692 A.2d 1089, 1095 (Pa. 1997); *Peerless Ins. Co. v. Viegas*, 667 A.2d 785, 787 (R.I. 1995); *First Fin. Ins. Co. v. Sea Island Sport Fishing Soc'y, Inc.*, 490 S.E.2d 257, 258 (S.C. 1997); *City of Ft. Pierre v. United Fire & Cas. Co.*, 463 N.W.2d 845, 847 (S.D. 1990); *St. Paul Fire & Marine Ins. Co. v. Torpoco*, 879 S.W.2d 831, 834-35 (Tenn. 1994); *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 821 (Tex. 1997); *Select Design, Ltd. v. Union Mut. Fire Ins. Co.*, 674 A.2d 798, 800 (Vt. 1996); *Brenner v. Lawyers Title Ins. Corp.*, 397 S.E.2d 100, 102 (Va. 1990); *State Bancorp, Inc. v. United States Fidelity & Guar. Ins. Co.*, 483 S.E.2d 228, 233 (W. Va. 1997) (quoting *Horace Mann Ins. Co. v. LEEBER*, 376 S.E.2d 581 (W. Va. 1988)); *Reisig v. Union Ins. Co.*, 870 P.2d 1066, 1068 (Wyo. 1994).

21. See *Federal Ins. Co. v. Stroh Brewing Co.*, 127 F.3d 563, 566 (7th Cir. 1997) (interpreting Indiana law); *Commercial Union Ins. Co. v. Alves*, 677 A.2d 70, 72 (Me. 1996); *Farmers Ins. Co. v. Romas*, 947 P.2d 754, 757-58 (Wash. Ct. App. 1997); *Doyle v. Engelke*, 580 N.W.2d 245, 248 (Wis. 1998); *Sharon Steel Corp. v. Aetna Cas. & Sur. Co.*, 931 P.2d 127, 133 (Utah 1997).

rule is only an *inclusionary* standard. In other words, every complaint or petition alleging a covered cause of action gives rise to a duty to defend. The eight corners rule, however, is not a valid *exclusionary* standard, meaning that the plaintiff's pleaded allegations should not be dispositive of the insurer's defense obligation. The eight corners rule wrongly shifts courts' and insurers' focus to the four corners of the complaint or petition, rather than training attention on the four corners of the policy where it belongs.²² The rule potentially allows an insurer to deny its insured a defense even if the insurer is aware of facts which, if pleaded, would entitle the insured to a defense. Insureds understandably argue that truth and knowledge do not count under the eight corners rule.

Second, the liberal notice pleading allowed in federal courts and most jurisdictions seriously undermines the already questionable validity of the eight corners rule.²³ Notice pleading embodies a very basic style and lends itself to vague allegations, such that the facts on which an insurer's duty to defend may be premised often are unknown or unknowable from the face of the petition or complaint. An insured should not be denied a valuable defense because of a plaintiff's cursory, vague or unartful pleading.²⁴ As the *Aetna Casualty & Surety Co. v. Sunshine Corp.*²⁵ court observed:

It is true that the duty of an insurance company to defend its insured is determined by the allegations of the pleading in which the claim against the insured is asserted. . . . But this does not mean that a particular choice of [language] by the draftsman of a complaint against the insured can deprive the insured of its contractual right to an insurer-provided defense in a situation where the plaintiff could recover a judgment for damages against the insured even if the [language of the complaint] should prove ill-chosen.²⁶

In short, a third-party claimant should not be allowed to determine the insured's rights under its insurance policy.²⁷

Finally, the eight corners rule promotes collusion between insureds and plaintiffs. An insured who fears being undefended can approach the

22. See *Great Am. Ins. Co. v. Hartford Ins. Co.*, 621 N.E.2d 796, 798-99 (Ohio Ct. App. 1993) (observing that "the duty to defend could attach at some later stage even though the complaint does not specifically establish the duty").

23. See, e.g., *First Nat'l Bank v. Fidelity & Deposit Co.*, 545 N.W.2d 332, 335-36 (Iowa Ct. App. 1996); *Mumford v. Interplast, Inc.*, 696 N.E.2d 259, 262-63 (Ohio Ct. App. 1997).

24. See *Aetna Cas. & Sur. Co. v. Cochran*, 651 A.2d 859, 865-66 (Md. 1995).

25. 74 F.3d 685 (6th Cir. 1996).

26. *Id.* at 688 (citation omitted); see also *Gibson v. Farm Family Mut. Ins. Co.*, 673 A.2d 1350, 1352 (Me. 1996) ("An insured is not at the mercy of the notice pleading of the third party suing him to establish his own insurer's duty to defend.").

27. See *Colonial Oil Indus., Inc. v. Underwriters Subscribing to Policy Nos. TO31504670 and TO31504671*, 491 S.E.2d 337, 339 (Ga. 1997); *Employers Mut. Cas. Co. v. Cedar Rapids Television Co.*, 552 N.W.2d 639, 643-44 (Iowa 1996).

plaintiff with a copy of his insurance policy and help the plaintiff craft an amended complaint or petition that is sure to trigger coverage.²⁸ Such behavior has untold economic consequences for insurers and it may have ethical ramifications for the lawyers involved.

A significant minority of courts have expanded on the eight corners rule, sometimes requiring insurers to look beyond the pleadings to determine if they owe their insureds a defense.²⁹ Under this approach, extrinsic evidence may trigger an insurer's duty to defend. An insurer "cannot ignore safely actual facts known to it or which could be known . . . from reasonable investigation."³⁰ It is the actual facts known to or ascertainable by the insurer that control the duty to defend—not just the allegations in the petition or complaint.³¹ The complaint or petition is merely the starting point in analyzing the insurer's duty to defend. The consideration of extrinsic evidence when analyzing the duty to defend is the more sensible approach, for an insurer should not be allowed to avoid its contractual duty by ignoring actual facts, nor should an insured be penalized for a plaintiff's unfortunate draftsmanship.

The value to insureds of the extrinsic evidence approach, and the reasonableness of this approach in light of the purpose of liability insurance, is easily understood by way of example. Suppose that a

28. See *Blackburn v. Fidelity & Deposit Co.*, 667 So. 2d 661, 670 (Ala. 1995) ("If a complaint that did not allege acts covered by an insurance policy is amended to add allegations . . . that are covered under the policy, the insurer's duty to defend is then activated.").

29. See, e.g., *State Dept. of Transp. and Pub. Facilities v. State Farm Fire & Cas. Co.*, 939 P.2d 788, 792 n.1 (Alaska 1997); *Waller v. Truck Ins. Exch.*, 900 P.2d 619, 627 (Cal. 1995); *Penn-America Ins. Co. v. Disabled Am. Veterans*, 490 S.E.2d 374, 376 (Ga. 1997); *Indiana Farmers Mut. Ins. Co. v. Ellison*, 679 N.E.2d 1378, 1382 (Ind. Ct. App. 1997); *Spivey v. Safeco Ins. Co.*, 865 P.2d 182, 188 (Kan. 1993); *Litz v. State Farm Fire & Cas. Co.*, 695 A.2d 566, 570 (Md. 1997); *American Bumper & Mfg. Co. v. Hartford Fire Ins. Co.*, 550 N.W.2d 475, 481 (Mich. 1996); *Garvis v. Employers Mut. Cas. Co.*, 497 N.W.2d 254, 258 (Minn. 1993); *Standard Artificial Limb, Inc. v. Allianz Ins. Co.*, 895 S.W.2d 205, 210 (Mo. Ct. App. 1995); *Mapes Indus., Inc. v. United States Fidelity & Guar. Co.*, 560 N.W.2d 814, 817 (Neb. 1997); *SL Indus., Inc. v. American Motorists Ins. Co.*, 607 A.2d 1266, 1272 (N.J. 1992); *Fitzpatrick v. American Honda Motor Co.*, 575 N.E.2d 90, 93-94 (N.Y. 1991); *Deseret Fed. Sav. & Loan Ass'n v. United States Fidelity & Guar. Co.*, 714 P.2d 1143, 1147 (Utah 1986); *Atlantic Mut. Ins. Co. v. Roffe, Inc.*, 872 P.2d 536, 538 (Wash. Ct. App. 1994) (quoting *E-Z Loader Boat Trailers, Inc. v. Travelers Indem. Co.*, 726 P.2d 439, 444 (Wash. 1986)).

30. *Standard Artificial Limb, Inc. v. Allianz Ins. Co.*, 895 S.W.2d 205, 210 (Mo. Ct. App. 1995)

31. See *Penn-America Ins. Co. v. Disabled Am. Veterans*, 490 S.E.2d 374, 376 (Ga. 1997); *Standard Artificial Limb*, 895 S.W.2d at 210.

plaintiff claims that an insured attacked and injured him, and that he did so intentionally and willfully. The plaintiff pleads an intentional tort in his petition. When the insured tenders the matter to his insurer, the insurer refuses to defend. The insurance company, having compared the plaintiff's petition with its policy, contends that there is no "occurrence" giving rise to coverage under the policy and, even if there were, the intentional acts exclusion in its policy excuses its duty to defend.³² In fact, the plaintiff was the aggressor, the insured was merely defending himself, and the insured neither expected nor intended the plaintiff's injuries. The insured explains the actual facts to the insurance company either upon tender or upon the insurer's denial of a defense. The insured may even document the actual facts by way of a police report or witness statements.

The eight corners rule allows the insurer to ignore the actual facts; the plaintiff's petition serves as a coverage fortress. The rule operates to deny the insured the defense for which he paid premiums, that he reasonably expects, and to which his policy entitles him. The insured's policy is meaningless and valueless unless the insurer rightly considers the extrinsic evidence. Resort to extrinsic evidence is necessary to enforce the parties' contract.

Although an insurer may be required to consider extrinsic evidence when evaluating its duty to defend, such consideration has reasonable limits. The extrinsic evidence must relate to or clarify the allegations in the plaintiff's complaint or petition.³³ If the insurer's review of extrinsic evidence reveals that the plaintiff has other claims against the insured for which he did not sue, the insurer can have no duty to defend based on those because they are not a part of the subject "suit."³⁴ And, while the insurer may have a duty to consider extrinsic evidence, the insured has an obligation to bring to the insurer's attention the extrinsic evidence it wants considered.³⁵ As a general rule, an insurer need not conduct an

32. An insurer has no duty to defend where the conduct complained of is clearly excluded under the policy. *See, e.g.,* Horace Mann Ins. Co. v. Peters, 948 P.2d 80, 85-86 (Colo. Ct. App. 1997); Littrell v. Colony Ins. Co., 492 S.E.2d 299, 299-300 (Ga. Ct. App. 1997); Jerge v. Buettner, 687 N.E.2d 1328 (N.Y. 1997); B.L.G. Enters., Inc. v. First Fin. Ins. Co., 491 S.E.2d 695, 697-98 (S.C. Ct. App. 1997); Farmers Tex. County Mut. Ins. Co. v. Griffin, 955 S.W.2d 81, 82-83 (Tex. 1997).

33. *See generally* Spruill Motors, Inc. v. Universal Underwriters Ins. Co., 512 P.2d 403, 407-408 (Kan. 1973) (indicating that extrinsic evidence triggering insurer's duty to defend must relate to or clarify the allegations in the plaintiff's petition).

34. As noted previously, a standard liability insurance policy provides that the insurer shall have the right and duty to defend any "suit" seeking specified damages. *See supra* note 10 and accompanying text.

35. *See* City of Salina, Kan. v. Maryland Cas. Co., 856 F. Supp. 1467, 1480 n.9 (D. Kan. 1994) (stating that insurer must consider facts "brought to its attention") (emphasis added).

independent investigation before rejecting its insured's demand for a defense.³⁶ The insurer must, however, communicate with the insured before unilaterally declining to defend.³⁷ A simple letter asking the insured to clarify its position with respect to potential coverage will suffice.³⁸ An insured that does not bring relevant extrinsic evidence to its insurer's attention cannot later complain that the insurer did not consider the evidence before declining to defend.³⁹

Regardless of the approach employed to determine an insurer's duty to defend, any questions about whether a defense is owed are always resolved in the insured's favor.⁴⁰ This principle is of tremendous economic importance to insureds, for defense costs may be ruinous. Defense costs may, and often do, exceed any settlement or judgment ultimately paid.⁴¹ Insureds' desire to secure a defense against third-party claims is probably as great a motive for purchasing liability insurance as is the need for potential indemnity.⁴² Because of its valuable defense component, liability insurance is essentially "litigation insurance."⁴³

36. *See id.*; but see *Koski v. Allstate Ins. Co.*, 572 N.W.2d 636, 639 n.5 (Mich. 1998) (recognizing that an insurer's duty to defend includes the duty to investigate whether the insured should be covered).

37. *See Towne Realty, Inc. v. Zurich Ins. Co.*, 548 N.W.2d 64, 67 (Wis. 1996), *reconsideration denied*, 555 N.W.2d 818 (Wis. 1996).

38. *See id.*

39. *See id.* n.2.

40. *See Horace Mann Ins. Co. v. Barbara B.*, 846 P.2d 792, 796 (Cal. 1993); *Scottsdale Ins. Co. v. Ratliff*, 927 S.W.2d 531, 534 (Mo. Ct. App. 1996); *Hart Constr. Co. v. American Family Mut. Ins. Co.*, 514 N.W.2d 384, 389 (N.D. 1994); *Klamath Pac. Corp. v. Reliance Ins. Co.*, 950 P.2d 909, 914 (Or. Ct. App. 1997); *Allstate Ins. Co. v. Russo*, 641 A.2d 1304, 1306 (R.I. 1994); *North Star Mut. Ins. Co. v. Kneen*, 484 N.W.2d 908, 912 (S.D. 1992); *Smith v. Katz*, 578 N.W.2d 202, 206 (Wis. 1998).

41. *See Allstate Ins. Co. v. RJT Enters., Inc.*, 692 So. 2d 142, 145 (Fla. 1997); *Sherwood Brands, Inc. v. Hartford Accident & Indem. Co.*, 698 A.2d 1078, 1083 (Md. 1997); *see also* Richard C. Giller, *Insurer's Right to Seek Reimbursement of Defense Costs: A National Perspective*, 17 *INS. LITIG. REP.* 132, 132 (1995) (arguing that the cost of providing a defense often exceeds the amount of settlement or judgement to be paid).

42. *See Montrose Chem. Corp. v. Superior Court*, 861 P.2d 1153, 1157 (Cal. 1993); *see also Campbell v. Superior Court*, 52 Cal. Rptr. 2d 385, 392 (Ct. App. 1996) ("[I]t is undeniable that insurance is purchased to provide the peace of mind and security that comes from knowing that if the insured contingency arises, the insurer will defend against the claim."); *General Accident Ins. Co. v. Insurance Co. of N. Am.*, 540 N.E.2d 266, 271 (Ohio 1989) (noting importance of duty to defend to insureds).

43. *See Allstate Ins. Co. v. Campbell*, 639 A.2d 652, 657 (Md. 1994) ("[A] liability insurance policy not only carries with it the promise to indemnify up to policy limits, but also the promise to defend; in that regard it is 'litigation insurance.'"); *International Paper Co. v. Continental Cas. Co.*, 320 N.E.2d 619, 621 (N.Y. 1974) (referring to liability insurance as "litigation insurance").

The duty to defend is a recurring source of questions and problems for insurers. Many problems are attributable to the timing of the duty's rise. Unlike an insurer's duty to indemnify, which arises only when the insured incurs liability for a claim⁴⁴ and thereby guarantees the insurer's obligation to pay only for a covered risk, the duty to defend arises upon the insured's tender.⁴⁵ An insurer's duty to defend is thus determined at the outset of the litigation, when coverage issues may be unclear, or when coverage questions are unanswered. A complaint or petition may contain both covered and uncovered claims, compelling the insurer to defend the entire action, even though the plaintiff's recovery ultimately may be founded on an uncovered claim for which the insurer owes no duty to indemnify.⁴⁶ The insurer's duty to defend does not depend upon the insured's ultimate liability. In this way an insurer's duty to defend is

44. See *Montrose Chem. Corp. v. Admiral Ins. Co.*, 913 P.2d 878, 883 n.9 (Cal. 1995); *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 607 N.E.2d 1204, 1221 (Ill. 1992); *Cambridge Mut. Fire Ins. Co. v. Perry*, 692 A.2d 1388, 1391 n.3 (Me. 1997); *South Macomb Disposal Auth. v. American Ins. Co.*, 572 N.W.2d 686, 711 (Mich. Ct. App. 1997) (quoting *Gelman Sciences, Inc. v. Fireman's Fund Ins. Cos.*, 455 N.W.2d 328, 330 (Mich. Ct. App. 1990)).

45. See *Purvis v. Hartford Accident & Indem. Co.*, 877 P.2d 827, 830 (Ariz. Ct. App. 1994); *Montrose Chem. Corp. v. Superior Court*, 861 P.2d 1153, 1157 (Cal. 1993); *Empire Fire & Marine Ins. Co. v. Clarendon Ins. Co.*, 642 N.E.2d 790, 793 (Ill. App. Ct. 1994), *appeal denied*, 649 N.E.2d 415 (Ill. 1995); *SCSC Corp. v. Allied Mut. Ins. Co.*, 533 N.W.2d 603, 614 (Minn. 1995), *rev'd on other grounds*, *SCSC Corp. v. Allied Mut. Ins. Co.*, 536 N.W.2d 305 (Minn. 1995); *First Bank of Turley v. Fidelity & Deposit Ins. Co.*, 928 P.2d 298, 304 (Okla. 1996); *George Sollitt Corp. v. Howard Chapman Plumbing & Heating, Inc.*, 836 P.2d 851, 852-53 (Wash. Ct. App. 1992).

"Tender" refers to the insured's request to its insurance company that the insurer defend it against a particular claim or suit. See *First Bank of Turley*, 928 P.2d at 304. Effective tender requires at a minimum that the insured give the insurer actual notice of the claim or suit. See *Federated Mut. Ins. Co. v. State Farm Mut. Auto Ins. Co.*, 668 N.E.2d 627, 633 (Ill. App. Ct. 1996); *White Mountain Constr. Co. v. Transamerica Ins. Co.*, 631 A.2d 907, 910 (N.H. 1993); *Harwell v. State Farm Mut. Auto. Ins. Co.*, 896 S.W.2d 170, 174 (Tex. 1995); *Towne Realty, Inc. v. Zurich Ins. Co.*, 548 N.W.2d 64, 67 (Wis. 1996). Depending on the jurisdiction, effective tender may require more than mere notice to the insurer. Some courts require that an insured make an "unequivocal and explicit" demand for a defense. *Purvis*, 877 P.2d at 831; *cf.* *SCSC Corp. v. Allied Mut. Ins. Co.*, 536 N.W.2d 305, 316 (Minn. 1995) (requiring "formal tender" of defense, presumably in the form of a letter).

46. If a single pleaded theory is covered, the insurer must defend the entire action, even if the policy specifically excludes coverage for other causes of action. See *National Union Fire Ins. Co. v. Glenview Park Dist.*, 632 N.E.2d 1039, 1042-43 (Ill. 1994); *MGM, Inc. v. Liberty Mut. Ins. Co.*, 855 P.2d 77, 79-80 (Kan. 1993) (quoting *State Farm Fire & Cas. Ins. Co. v. Finney*, 770 P.2d 460, 466 (Kan. 1989)); *Employees Ins. Representatives, Inc. v. Employers Reinsurance Corp.*, 653 So. 2d 27, 29 (La. Ct. App. 1995), *writ denied*, 658 So. 2d 1268 (La. 1995); *Frontier Insulation Contractors, Inc. v. Merchants Mut. Ins. Co.*, 690 N.E.2d 866, 869 (N.Y. 1997); *Town of Duncan v. State Budget & Control Bd.*, 482 S.E.2d 768, 773-74 (S.C. 1997) (construing *Employers Mut. Liab. Ins. Co. v. Hendrix*, 199 F.2d 53 (4th Cir. 1952)); *Drexel Chem. Co. v. Bituminous Ins. Co.*, 933 S.W.2d 471, 480 (Tenn. Ct. App. 1996).

broader than its duty to indemnify.⁴⁷

When coverage is an issue, an insurer called upon to defend its insured has three options. First, it can simply defend the suit. Second, it can refuse to defend. Third, it can defend the insured under a reservation of rights.⁴⁸ As a common variation on the third option, an insurer may defend pursuant to a non-waiver agreement with the insured.⁴⁹

If the insurer selects the first option, it waives any coverage defenses that it may have,⁵⁰ or it will be estopped from asserting them later.⁵¹ The insurer also assumes the cost of the insured's defense. The cost may be significant, for the insurer's defense obligation continues throughout the course of the litigation against the insured.⁵² An insurer's duty to defend may even include a duty to appeal on the insured's behalf.⁵³

If the insurer selects the second option and declines to defend its

47. It is well-established that an insurer's duty to defend is broader than its duty to indemnify. *See, e.g.*, *Aerojet-General Corp. v. Transport Indem. Co.*, 948 P.2d 909, 921 (Cal. 1997); *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991); *Allstate Ins. Co. v. RJT Enters., Inc.*, 692 So. 2d 142, 144 (Fla. 1997); *Commerce & Indus. Ins. Co. v. Bank of Haw.*, 832 P.2d 733, 735 (Haw. 1992); *Indiana Farmers Mut. Ins. Co. v. Ellison*, 679 N.E.2d 1378, 1381-82 (Ind. Ct. App. 1997); *Essex Ins. Co. v. Fieldhouse, Inc.*, 506 N.W.2d 772, 775 (Iowa 1993); *Yount v. Maisano*, 627 So. 2d 148, 153 (La. 1993); *Hanover Ins. Co. v. Crocker*, 688 A.2d 928, 929-30 n.1 (Me. 1997); *Doe v. Liberty Mut. Ins. Co.*, 667 N.E.2d 1149, 1151 (Mass. 1996); *Auto Owners Ins. Co. v. City of Clare*, 521 N.W.2d 480, 487 (Mich. 1994); *Auto-Owners Ins. Co. v. Todd*, 547 N.W.2d 696, 698 (Minn. 1996); *Chase Resorts, Inc. v. Safety Mut. Cas. Corp.*, 869 S.W.2d 145, 150 (Mo. Ct. App. 1993); *John Markel Ford, Inc. v. Auto-Owners Ins. Co.*, 543 N.W.2d 173, 179 (Neb. 1996); *Estate of Teel v. Darby*, 500 S.E.2d 759, 763 (N.C. Ct. App. 1998); *Sharon Steel Corp. v. Aetna Cas. & Sur. Co.*, 931 P.2d 127, 133 (Utah 1997); *Select Design, Ltd. v. Union Mut. Fire Ins. Co.*, 674 A.2d 798, 800 (Vt. 1996); *Virginia Elec. & Power Co. v. Northbrook Property & Cas. Ins. Co.*, 475 S.E.2d 264, 266 (Va. 1996); *First Wyo. Bank v. Continental Ins. Co.*, 860 P.2d 1094, 1097 (Wyo. 1993).

48. *See State ex rel. Rimco, Inc. v. Dowd*, 858 S.W.2d 307, 308 (Mo. Ct. App. 1993).

49. *See infra* notes 70-72 and accompanying text.

50. *See Ogden v. United States Fidelity & Guar. Co.*, 933 P.2d 1200, 1204 (Ariz. Ct. App. 1996); *Truck Ins. Exch. v. Superior Court*, 59 Cal. Rptr. 2d 529, 533 (Ct. App. 1996).

51. *See Doe v. Allstate Ins. Co.*, 653 So. 2d 371, 374 (Fla. 1995); *AIG Haw. Ins. Co. v. Smith*, 891 P.2d 261, 264-67 (Haw. 1995); *Mobil Oil Corp. v. Maryland Cas. Co.*, 681 N.E.2d 552, 560 (Ill. App. Ct. 1997).

52. *See Lambert v. Commonwealth Land Title Ins. Co.*, 811 P.2d 737, 739 (Cal. 1991); *Continental Ins. Co. v. Burr*, 706 A.2d 499, 502 (Del. 1998); *Home Sav. Ass'n v. Aetna Cas. & Sur. Co.*, 854 P.2d 851, 855 (Nev. 1993); *Board of Pub. Educ. of Sch. Dist. of Pittsburgh v. National Union Fire Ins. Co.*, 709 A.2d 910, 913 (Pa. Super. Ct. 1998).

53. *See generally* Dennis J. Wall, *Insurer Good Faith in the Appellate Courts: Defend or Settle*, FOR THE DEF., June 1997, at 30.

insured, it must be certain that its choice is correct, for the consequences of a miscalculation may be grave. An insurance company's wrongful refusal to defend its insured is a breach of contract.⁵⁴ The insurer waives the opportunity to contest the insured's liability.⁵⁵ Such a breach may estop the insurer from raising policy exclusions or other coverage defenses in any subsequent action by the insured to recover policy proceeds,⁵⁶ or the breach may operate to waive the insurer's coverage defenses.⁵⁷ The insurer's breach of its duty to defend relieves the insured of its obligation to cooperate with the insurer in the defense of the suit and allows the insured to proceed in whatever manner it deems appropriate.⁵⁸ The insurer's breach may eliminate its right to demand that the insured comply with policy provisions.⁵⁹ For example, the insured may reasonably settle the plaintiff's claim without prior notice to or consent by the insurer.⁶⁰ The insurer's liability for a settlement within policy limits arguably makes some sense, for fundamental contract law requires that the policyholder be restored to the same position he would

54. See *Cambridge Mut. Fire Ins. Co. v. Perry*, 692 A.2d 1388, 1391 (Me. 1997); *Whitehead v. Lakeside Hosp. Ass'n*, 844 S.W.2d 475, 481 (Mo. Ct. App. 1992); *Sanderson v. Ohio Edison Co.*, 635 N.E.2d 19, 23 (Ohio 1994); *First Bank of Turley v. Fidelity & Deposit Ins. Co.*, 928 P.2d 298, 305 (Okla. 1996); *Newhouse v. Citizens Sec. Mut. Ins. Co.*, 501 N.W.2d 1, 6 (Wis. 1993).

55. See *Morgan v. Guaranty Nat'l Cos.*, 489 S.E.2d 803, 805-06 (Ga. 1997).

56. See *Grindheim v. Safeco Ins. Co. of Am.*, 908 F. Supp. 794, 798 (D. Mont. 1995) (interpreting Montana law); *Bedoya v. Illinois Founders Ins. Co.*, 688 N.E.2d 757, 763 (Ill. Ct. App. 1997) (quoting *Fidelity & Cas. Co. v. Mobay Chem. Co.*, 625 N.E.2d 151, 155 (Ill. Ct. App. 1992)); *Insurance Co. of Ill. v. Federal Kemper Ins. Co.*, 683 N.E.2d 947, 949 (Ill. Ct. App. 1997).

57. See, e.g., *Nationwide Mut. Ins. Co. v. State Farm Mut. Auto. Ins. Co.*, 470 S.E.2d 556, 559-60 (N.C. Ct. App. 1996).

58. See *Eigner v. Worthington*, 66 Cal. Rptr. 2d 808, 813 (Ct. App. 1997); *D.E.M. v. Allickson*, 555 N.W.2d 596, 602 (N.D. 1996) (quoting *Brownsdale Coop. Ass'n v. Home Ins. Co.*, 473 N.W.2d 339, 341 (Minn. Ct. App. 1991)).

59. See *Whitehead v. Lakeside Hosp. Ass'n*, 844 S.W.2d 475, 481 (Mo. Ct. App. 1992).

60. See *Black v. Goodwin, Loomis & Britton, Inc.*, 681 A.2d 293, 298 (Conn. 1996); *MCO Envtl., Inc. v. Agricultural Excess & Surplus Ins. Co.*, 689 So. 2d 1114, 1116 (Fla. Dist. Ct. App. 1997); *Allickson*, 555 N.W.2d at 602; *Sanderson v. Ohio Edison Co.*, 635 N.E.2d 19, 23 (Ohio 1994); *Northwest Pump & Equip. Co. v. American States Ins. Co.*, 917 P.2d 1025, 1029 (Or. Ct. App.), *modified*, 925 P.2d 1241 (1996); *Gibbs M. Smith, Inc. v. United States Fidelity & Guar. Co.*, 949 P.2d 337, 344 (Utah 1997) (quoting *Waugh v. American Cas. Co.*, 378 P.2d 170, 177 (Kan. 1963)).

The test of whether such a settlement is reasonable "is what a reasonably prudent person in the position of the defendant would have settled for on the merits of the plaintiff's claim." *Gulf Ins. Co. v. Noble Broad.*, 936 S.W.2d 810, 816 (Mo. 1997). The insurer bears the burden of proving that a settlement taken without its consent is unreasonable. See *id.*

Similarly, any such settlement cannot be the product of fraud or collusion between or involving the insured and the plaintiff. As with reasonableness, the insurer bears the burden of establishing that a settlement was procured as a result of fraud or collusion. See *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 534 (Iowa 1995).

have occupied had there been no breach by the insurer.⁶¹

Of course, the insurer must reimburse the insured for the costs incurred by the insured in defending the suit.⁶² The insurer also becomes liable for all other consequential damages that flow naturally from its breach.⁶³ If defense costs and settlement or judgment amounts can be allocated between covered and uncovered claims they may be so allocated;⁶⁴ if not, as typically is the case, the insurer is wholly liable.⁶⁵

Only if it exercises its third option and defends the insured under a reservation of rights or pursuant to a non-waiver agreement can an insurer safely raise coverage defenses.⁶⁶ By effectively reserving its rights an insurer does not waive its coverage defenses and it cannot be estopped from later asserting them. A reservation of rights letter is simply an insurer's unilateral declaration that it is reserving its right to later deny coverage, despite its initial decision to defend. A reservation of rights letter does not evidence or imply the insured's consent to the insurer's conditional defense.⁶⁷ Even if the insured does not agree with

61. See Douglas R. Richmond, *An Overview of Insurance Bad Faith Law and Litigation*, 25 SETON HALL L. REV. 74, 83 (1994); see also *Jefferson Ins. Co. v. National Union Fire Ins. Co.*, 677 N.E.2d 225, 232 (Mass. App. Ct. 1997); *A.B.C. Builders, Inc. v. American Mut. Ins. Co.*, 661 A.2d 1187, 1191-92 (N.H. 1995); *Northwest Pump*, 917 P.2d at 1028 ("Because the duty to defend is contractual and settlement is a component of defending, it follows that settlement is part of the performance of an insurance contract.").

62. See *MCO Envtl., Inc. v. Agricultural Excess & Surplus Ins. Co.*, 689 So. 2d 1114, 1116 (Fla. Dist. Ct. App. 1997); *Litz v. State Farm Fire & Cas. Co.*, 695 A.2d 566, 573 (Md. 1997); *Preferred Mut. Ins. Co. v. Gamache*, 686 N.E.2d 989, 991 (Mass. 1997); *Concord Hosp. v. New Hampshire Med. Malpractice Joint Underwriting Ass'n*, 694 A.2d 996, 998 (N.H. 1997); *First Bank of Turley v. Fidelity & Deposit Ins. Co. of Md.*, 928 P.2d 298, 305 (Okla. 1996); *Kirk v. Mt. Airy Ins. Co.*, 951 P.2d 1124, 1126 (Wash. 1998).

63. See *MCO Envtl.*, 689 So. 2d at 1116; *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912, 922 (Mass. 1993); *Whitehead v. Lakeside Hosp. Ass'n*, 844 S.W.2d 475, 481 (Mo. Ct. App. 1992).

64. See *Grand Cove II Condominium Ass'n v. Ginsberg*, 676 A.2d 1123, 1131 (N.J. Super. Ct. App. Div. 1996).

65. See Richmond, *supra* note 61, at 83.

66. See *Townsend Ford, Inc. v. Auto-Owners Ins. Co.*, 656 So. 2d 360, 365 (Ala. 1995) (mentioning reservation of rights); *Wheeler v. Reese*, 835 P.2d 572, 577 (Colo. Ct. App. 1992) (discussing reservation of rights); *Hiser v. Rajki*, 700 So. 2d 1302, 1302 (La. Ct. App. 1997) (quoting *Steptore v. Masco Contr. Co.*, 643 So. 2d 1213, 1216 (La. 1994)) (discussing effect of non-waiver agreement); *Sands v. CIGNA Prop. & Cas. Ins. Co.*, 674 A.2d 169 (N.J. Super. Ct. App. Div. 1996) (suggesting that insurers should always defend under a reservation of rights when coverage is at issue).

67. Indeed, in some states an insured may reject a defense offered under reservation. See, e.g., *State Farm Mut. Auto. Ins. Co. v. Ballmer*, 899 S.W.2d 523, 527

or consent to the insurer's reservation of rights, however, the insurer's unilateral reservation generally remains effective.⁶⁸ Because the right to contest coverage is the insurer's alone it may be reserved unilaterally.⁶⁹

A non-waiver agreement is a contract between the insured and the insurer, whereby the insured agrees that the insurer retains the right to disclaim coverage and the insurer agrees to provide the insured with a defense until it does so.⁷⁰ A non-waiver agreement is bilateral, whereas a reservation of rights letter is unilateral.⁷¹ A non-waiver agreement is in effect a reservation of rights letter to which the insured consents.⁷²

A reservation of rights defense potentially benefits both the insurer and the insured. The insurer benefits by offering the insured a defense under reservation because by doing so it avoids potentially large liability for breaching its duty to defend without committing to the unnecessary expense of indemnifying the insured for uncovered liability.⁷³ The insured benefits by the insurer's defense under reservation because it does not have to fund the defense. Although there exists a risk that an insurer defending under a reservation of rights might pursue a declaratory judgment action to determine its contractual obligations, might withdraw its defense when it becomes clear that there is no coverage, or might later seek the reimbursement of funds it advances to settle the case,⁷⁴ insureds easily subordinate these concerns to the emotional and financial relief that an immediate defense affords. The same advantages and concerns attend a defense provided pursuant to a non-waiver agreement.

Insureds being defended under a reservation of rights or pursuant to a

(Mo. 1995).

68. See *Buss v. Superior Court*, 939 P.2d 766, 784 n.27 (Cal. 1997).

69. See *id.*

70. See Douglas R. Richmond, *Lost in the Eternal Triangle of Insurance Defense Ethics*, 9 GEO. J. LEGAL ETHICS 475, 490 n.72 (1996) [hereinafter *Lost in the Eternal Triangle*]; see also *Employers Ins. v. George*, 673 N.E.2d 572, 579 (Mass. App. Ct. 1996) (stating that an insurer's duty under a non-waiver agreement is to "participate in the defense until it exercise[s] its reserved right to disclaim").

71. See *Lost in the Eternal Triangle*, *supra* note 70, at 490 n.72.

72. See *JERRY*, *supra* note 8, at 795.

73. See Steve Becker, Comment, *The Refusal of Reservation of Rights Defenses [sic] and Statutory Settlement Agreements in Missouri*, 64 UMKC L. REV. 787, 791 (1996).

74. See, e.g., *Medical Malpractice Joint Underwriting Ass'n v. Goldberg*, 680 N.E.2d 1121 (Mass. 1997). The *Goldberg* court held:

Where an insurer defends under a reservation of rights to later disclaim coverage, . . . it may later seek reimbursement for an amount paid to settle the underlying tort action only if the insured has agreed that the insurer may commit the insured's own funds to a reasonable settlement with the right later to seek reimbursement from the insured, or if the insurer secures specific authority to reach a particular settlement which the insured agrees to pay.

Id. at 1129.

non-waiver agreement have seldom worried about insurers' potential recoupment of defense costs.⁷⁵ Even if insurers have enjoyed the right to recover defense costs attributable to uncovered claims or suits, they typically have not attempted to do so.⁷⁶ Insurers have viewed conditional defenses as a cost of doing business; in "mixed actions," i.e., cases in which some claims potentially are covered and some are not, defending uncovered claims is to be expected. In some cases, the defense costs that can be allocated to uncovered claims are not so great as to justify litigating their recovery. It may not be possible to apportion defense costs between covered and uncovered claims.⁷⁷ Regardless, insureds generally have come to view a defense under reservation in the same light as an unconditional defense.⁷⁸ That view has always been inaccurate and unrealistic. Insureds who are being defended under reservation in mixed actions must examine their exposure following *Buss v. Superior Court*.⁷⁹

Insurers' right to reimbursement should most concern commercial insureds. Defense costs in commercial cases often far exceed those incurred in defenses provided under personal lines policies. Logically, insurers should be willing to fund litigation to recoup defense costs only where those costs are substantial. Commercial insureds are much more likely to have the financial resources to reimburse insurers for defense costs attributable to uncovered claims. Insurers are likely willing to spend time or money attempting to recover defense costs only from those insureds who can reasonably bear them. Thus, most homeowners and individuals insured under automobile and other liability policies are

75. See Michael Sean Quinn, *Reserving Rights Rightly: The Romance and the Temptations*, COVERAGE, July/August 1997, at 23, 33. In the remainder of this Article, a defense provided in accordance with a reservation of rights letter or a defense provided pursuant to a non-waiver agreement often will be referred to simply as a defense provided "under reservation."

76. See *Travelers Ins. Co. v. Leshner*, 231 Cal. Rptr. 791, 809 (Ct. App. 1986) (noting undisputed evidence that "it was not the practice of Travelers or other insurers to seek recovery of attorney's fees in cases defended under a reservation of rights"), *disapproved by Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997).

77. See, e.g., *Gibson v. Farm Family Mut. Ins. Co.*, 673 A.2d 1350, 1354 (Me. 1996).

78. This statement is not uniformly true, of course. Insureds sometimes fear that reservation of rights defenses create conflicts of interest for insurance defense counsel. See generally *Lost in the Eternal Triangle*, *supra* note 70, at 485-95.

79. 939 P.2d 766 (Cal. 1997). The court held that an insurer has a right of reimbursement for defense costs in a "mixed" action for claims not potentially covered by the policy. *Id.* at 776.

less vulnerable to reimbursement actions.

III. WAITING FOR THE *BUSS*

Liability insurers' right to reimbursement of defense costs incurred in connection with uncovered claims can be traced to dicta in a 1975 California decision, *Johansen v. California State Automobile Ass'n Inter-Insurance Bureau*.⁸⁰ Discussing an insurer's settlement of a case in which coverage is disputed, the *Johansen* court observed that if an insurer has reserved its rights and reasonably settles the case, and "subsequently establishes the noncoverage of its policy, it would be free to seek reimbursement of the settlement payment from its insured."⁸¹ The *Johansen* dicta was transformed into law by a California Court of Appeal that same year in *Val's Painting & Drywall, Inc. v. Allstate Insurance Co.*⁸²

Although born in relation to the duty to indemnify, it is not surprising that the right to reimbursement moved to the duty to defend. Defense costs are a significant financial concern for liability insurers.⁸³ Fourteen cents out of every dollar insurers spend on liability claims goes to pay defense costs.⁸⁴ To the extent they can recoup defense costs attributable to uncovered claims or causes of action, insurers are dollars ahead.

This Section first discusses insurers' right to reimbursement of defense costs as it developed in California. The right to reimbursement developed in a series of state and federal decisions, the most significant of which this Article treats in chronological order.⁸⁵ Following that survey is a discussion of the Supreme Court of California's decision in *Buss v. Superior Court*.⁸⁶ Finally, this Section analyzes other jurisdictions' treatment of insurers' claimed right to the reimbursement of defense costs attributable to uncovered claims.

80. 538 P.2d 744 (Cal. 1975).

81. *Id.* at 750.

82. 126 Cal. Rptr. 267, 270, 273-74 (Ct. App. 1975).

83. See generally Karen A. Reardon et al., *If You Paid for Legal Services Recently, Chances Are You Paid Too Much: Hourly Billing and the "Reasonable" Attorney Fee Standard*, CPCU J., Sept. 1995, at 145, 146 (discussing tort system's increasing costs and resulting financial pressures on insurers).

84. See INSURANCE INFORMATION INST., THE FACT BOOK 1998: PROPERTY/CASUALTY INSURANCE FACTS 54 (1997).

85. This Article does not discuss all California decisions on the topic.

86. 939 P.2d 766 (Cal. 1997).

A. *The Development of California Law*1. *Cases*

Insurers' right to reimbursement of their costs incurred defending uncovered claims first surfaced, albeit shrouded in implication, in *Safeco Title Insurance Co. v. Moskopoulos*.⁸⁷ In *Moskopoulos*, real estate broker Paris Moskopoulos tendered his defense in a suit stemming from a flawed sale of residential property to Safeco, the title insurer on the property.⁸⁸ Safeco agreed to defend Moskopoulos with counsel of his choice, subject to a reservation of rights.⁸⁹ Safeco reserved its right to assert that it had no duty to defend Moskopoulos, and its right to recover its attorneys' fees expended in his defense.⁹⁰ Safeco filed a declaratory judgment action against Moskopoulos several months after assuming his defense.⁹¹

The trial court entered judgment for Safeco, holding that it had no duty to defend, and Moskopoulos appealed.⁹² The appellate court likewise concluded that Safeco had no duty to defend Moskopoulos in the third-party action, and affirmed the trial court.⁹³

Moskopoulos did not even discuss Safeco's right to reimbursement of its defense costs and the court never held that an insured may be required to reimburse an insurer for the defense of uncovered claims or suits. Yet, some commentators suggest that *Moskopoulos* "specifically addressed this issue."⁹⁴ The *Moskopoulos* court did no such thing. Even reading *Moskopoulos* most generously, the court only implicitly recognized insurers' right to reimbursement.

An insurer's right to reimbursement next became an issue approximately two years later in *Western Employers Insurance Co. v. Arciero & Sons, Inc.*⁹⁵ In *Arciero*, the insured, Arciero & Sons, was a general contractor on a condominium project. When a retaining wall collapsed after the project was completed, the condominium owners

87. 172 Cal. Rptr. 248 (Ct. App. 1981).

88. *See id.* at 249-50.

89. *See id.* at 250.

90. *See id.* at 250-51.

91. *See id.* at 251.

92. *See id.* at 249.

93. *See id.* at 251-53.

94. *See, e.g.,* Giller, *supra* note 41, at 133 & n.12.

95. 194 Cal. Rptr. 688 (Ct. App. 1983).

sued Arciero & Sons for damage to the wall, the slope held by the wall, and the condominium units.⁹⁶

Arciero & Sons tendered its defense to Western, its general liability insurer. Western accepted the defense under a reservation of rights. Western settled the condominium owners' claims and then sued Arciero & Sons for declaratory relief and to recover the sums it paid to defend and settle the condominium owners' suit.⁹⁷ The trial court granted summary judgment for Western, holding that the damage to the wall, slope, and condominium units was not covered. The court of appeal affirmed the trial court's ruling.⁹⁸

The *Arciero* court neither discussed nor endorsed Western's claimed right to reimbursement.⁹⁹ The court apparently assumed, as did the parties, that the insurer's right to reimbursement followed automatically if a defense was never owed. Arciero & Sons did not appear to dispute Western's right to reimbursement. *Arciero* does not hold as a matter of law that an insurer is entitled to recover its costs incurred in the defense of an uncovered suit,¹⁰⁰ as the Ninth Circuit would correctly observe a few years later in *St. Paul Mercury Insurance Co. v. Ralee Engineering Co.*¹⁰¹ Nonetheless, *Arciero*, like its relative *Moskopoulos*, is wrongly cited as support for insurers' right to reimbursement.¹⁰²

In *Ralee*, insurers' right to reimbursement of defense costs was squarely presented as an issue for the first time. The *Ralee* insurer, St. Paul, reserved its right to deny coverage and to withdraw its defense of an employment action.¹⁰³ St. Paul's reservation of rights letter to the insured provided:

For the foregoing reasons, in undertaking your defense, or conducting any investigation it is to be clearly understood we are not waiving any right we have to deny coverage or refuse to defend you further at any future time, and we hereby specifically reserve our right to do so without prejudice to any other rights you or we may have under the policy.¹⁰⁴

It was ultimately determined that the St. Paul policy did not afford coverage and that St. Paul did not owe a duty to defend, and the insurer therefore contended that it was entitled to be reimbursed for the costs it

96. *See id.* at 688.

97. *See id.*

98. *See id.* at 689.

99. *See id.* at 689-91.

100. *See St. Paul Mercury Ins. Co. v. Ralee Eng'g Co.*, 804 F.2d 520, 522 (9th Cir. 1986) (interpreting *Arciero* and California law).

101. 804 F.2d 520 (9th Cir. 1986).

102. *See, e.g.*, Giller, *supra* note 41, at 133 & n.12.

103. *See Ralee*, 804 F.2d at 521-22.

104. *Id.* at 522 (quoting St. Paul reservation of rights letter).

incurred in defending its insured.¹⁰⁵ The *Ralee* court rejected all of St. Paul's arguments.

St. Paul first argued that *Arciero*¹⁰⁶ supported its right to reimbursement. The Ninth Circuit succinctly rejected this argument for the reasons noted above.¹⁰⁷ The court further relied on the parties' apparent understanding of their respective rights to deny St. Paul's claim. There was nothing in the record suggesting that the insured understood that it would be obligated to reimburse St. Paul for its defense costs if St. Paul eventually declined to defend the third-party action.¹⁰⁸ In fact, St. Paul's statement in its reservation of rights letter that it might refuse to defend "further at any future time"¹⁰⁹ suggested a contrary understanding.¹¹⁰

Although the Ninth Circuit in *Ralee* denied the insurer reimbursement, the court planted two important seeds. First, the *Ralee* court appeared to suggest to insurers that if they wanted to recover their costs associated with the defense of uncovered claims, they should expressly state their intention to do so in reservation of rights letters. Second, an insured must understand the insurer's intention and right to seek the reimbursement of defense costs attributable to uncovered claims or actions before reimbursement will be allowed.¹¹¹

Within months of the Ninth Circuit's decision in *Ralee*, a California appellate court authored *Travelers Insurance Co. v. Leshner*.¹¹² In *Leshner*, Travelers' insured, Dean Leshner, was sued for alleged antitrust violations. Leshner tendered his defense to Travelers, which agreed to defend him under a reservation of rights.¹¹³ Travelers' reservation of rights letter made no mention of the insurer's intention to seek the reimbursement of its attorneys' fees should it later be determined that its policy did not afford coverage.¹¹⁴

105. *See id.*

106. *Western Employers Ins. Co. v. Arciero & Sons, Inc.*, 194 Cal. Rptr. 688 (Ct. App. 1983). *Arciero* is discussed at *supra* notes 95-100 and the accompanying text.

107. *See Ralee*, 804 F.2d at 522; *see also supra* notes 99-101 and accompanying text.

108. *See Ralee*, 804 F.2d at 522.

109. *Id.* (emphasis added).

110. *See id.*

111. *See id.* at 522-23.

112. 231 Cal. Rptr. 791 (Ct. App. 1986), *disapproved by* *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997).

113. *See id.* at 794.

114. *See id.* at 809.

Travelers filed a declaratory judgment action in an effort to determine that it had no duty to defend or indemnify Lesher and to obtain reimbursement of its costs incurred defending the antitrust suit.¹¹⁵ The trial court granted Travelers' motion for summary judgment on its claim that it had no duty to defend or indemnify Lesher, but allowed Travelers' alleged entitlement to recover its fees and costs to proceed to trial. Lesher cross-claimed against Travelers on several theories.¹¹⁶ At trial, the court granted Lesher's motion for non-suit on Travelers' fee claim. The jury returned a bad faith verdict against Travelers on Lesher's cross-claim. Travelers then appealed from the order of non-suit and from the judgment on the jury verdict.¹¹⁷

As to its claimed entitlement to recover defense costs, Travelers first argued on appeal that its "complete reservation of rights" was sufficient to require the submission of the issue to the jury.¹¹⁸ The appellate court disagreed. The insurer's reservation of rights letter did not address the possible reimbursement of defense costs. The evidence was undisputed that it was the practice of Travelers and other insurers not to seek the recovery of attorneys' fees in cases defended under a reservation of rights.¹¹⁹ The Travelers claim representative who sent the reservation of rights letter testified that he did not intend in the letter to advise Lesher that the company might seek the reimbursement of its attorneys' fees.¹²⁰ The *Lesher* court thus concluded that Travelers' reservation of rights was insufficient to entitle it to reimbursement.

In a final "cursory argument," Travelers suggested that it had a right to reimbursement sounding "in the equitable doctrine of quasi-contract or restitution."¹²¹ The *Lesher* court rejected this argument as well. The court observed that under "settled principles of restitution . . . a person who, incidental to the performance of his own duty or to the protection of his own things, has conferred a benefit upon another, is not thereby entitled to contribution."¹²² An insurer that defends under a reservation of rights because coverage is uncertain does so largely to protect itself from a claim that it breached its contract with the insured.¹²³ Although a defense under reservation also benefits the insured, the insurer does not primarily undertake the defense for the insured's benefit.¹²⁴

115. *See id.* at 794.

116. *See id.*

117. *See id.*

118. *Id.* at 809.

119. *See id.*

120. *See id.*

121. *Id.*

122. *Id.*

123. *See id.*

124. *See id.* at 809-10.

Accordingly, the doctrine of restitution did not permit Travelers' recovery of defense costs.¹²⁵

Insurers' recovery of their defense costs associated with uncovered claims based on the principle of restitution was next discussed in *Insurance Co. of the West v. Haralambos Beverage Co.*¹²⁶ The *Haralambos* court rejected the insurer's argument that it was entitled to restitution, first observing that in restitution, "money voluntarily paid to another with knowledge of the facts cannot be recovered back."¹²⁷ The court embraced the reasoning of the *Leshner*¹²⁸ court that an insurer's motivation in defending under a reservation of rights is the protection of its own interests rather than those of the insured, such that restitution is unavailable.¹²⁹

The *Haralambos* court noted that an insurer may recover its defense costs if there is an understanding between the parties that the insured will reimburse the insurer for those costs should coverage issues ultimately be adjudicated in the insurer's favor.¹³⁰ Unfortunately for the insurer, the court concluded that there was no evidence of such an agreement; neither the reservation of rights letter nor an "oral reservation of rights" were sufficient to establish the insured's knowledge of the insurer's right to reimbursement.¹³¹

In *Omaha Indemnity Insurance Co. v. Cardon Oil Co.*,¹³² Omaha Indemnity sent a reservation of rights letter clearly, unequivocally and repeatedly stating its intention to seek the reimbursement of its defense costs.¹³³ It was undisputed that the insureds knew "of Omaha Indemnity's intention to seek reimbursement."¹³⁴ The insureds argued, however, that they never indicated any understanding or agreement that they accepted the insurer's reservation of rights insofar as it related to the recovery of defense expenditures.¹³⁵ The insureds maintained that their silence could not be construed as acquiescence. In short, Omaha

125. *See id.* at 810.

126. 241 Cal. Rptr. 427 (Ct. App. 1987), *disapproved by* Buss v. Superior Court, 939 P.2d 766 (Cal. 1997).

127. *Id.* at 434.

128. *See supra* notes 112-25 and accompanying text.

129. *See Haralambos*, 241 Cal. Rptr. at 434-35.

130. *See id.* at 434.

131. *See id.* at 434-35.

132. 687 F. Supp. 502 (N.D. Cal. 1988), *aff'd*, 902 F.2d 40 (9th Cir. 1990).

133. *See id.* at 504.

134. *Id.*

135. The insureds did not respond to the reservation of rights letter. *See id.*

Indemnity's unilateral reservation of rights was ineffective when it came to the reimbursement of defense costs.¹³⁶

The *Omaha Indemnity* court rejected the insureds' argument, reasoning that the insureds' silence should be deemed acquiescence in light of the insurer's reservation of rights letter explicitly advising the insureds that it was reserving its right to reimbursement and that it would seek reimbursement in a court action.¹³⁷ Because the insureds did not expressly refuse to consent to the insurer's reservation of rights, the court held that *Omaha Indemnity* adequately reserved its right to reimbursement. The court granted *Omaha Indemnity*'s summary judgment motion and ordered the insureds to reimburse the insurance company for nearly \$500,000 in litigation expenses.¹³⁸

After *Omaha Indemnity*, the logical next step was a case in which the insured *did* object to the insurer's reservation of rights. That case turned out to be *Walbrook Insurance Co. v. Goshgarian & Goshgarian*.¹³⁹ In *Walbrook*, like *Omaha Indemnity*, the insurer sent an explicit reservation of rights letter, specifically reserving its right to recover all sums expended "for defense, settlement or the satisfaction of the judgment."¹⁴⁰ Unlike the insureds in *Omaha Indemnity*, however, the *Walbrook* insureds twice objected to the reservation of rights by twice writing to the insurer refusing to consent to or acknowledge the validity of those rights.¹⁴¹

Their protests notwithstanding, the insureds accepted *Walbrook*'s defense payments for their independent counsel totalling \$500,000.¹⁴² The acceptance of these defense expenditures betrayed them. The *Walbrook* court reasoned that the insureds' acceptance of the insurer's defense payments was "inconsistent with their objections, as they [were] refusing to accept the agreement yet retaining the fruits of it."¹⁴³ The court held that the insureds' acceptance of the insurer's monies constituted an implied agreement to the reservation of rights.¹⁴⁴

Finally,¹⁴⁵ the court in *American Motorists Insurance Co. v. Allied-*

136. *See id.*

137. *See id.* at 505.

138. *See id.*

139. 726 F. Supp. 777 (C.D. Cal. 1989).

140. *Id.* at 782.

141. *See id.*

142. *See id.*

143. *Id.* at 784.

144. *See id.*

145. There are California cases decided after the last cases discussed here in which an insurer's right to recoup its defense costs was an issue. *See, e.g., Richardson v. State Farm Fire & Cas. Co.*, 37 Cal. Rptr. 2d 824 (Ct. App. 1995), *review denied and op. ordered depublished*, 37 Cal. Rptr. 2d 824 (Cal. 1995); *Gossard v. Ohio Cas. Group of Ins. Cos.*, 35 Cal. Rptr. 2d 190 (Ct. App. 1994), *review granted and op. superseded*, 888

*Sysco Food Services, Inc.*¹⁴⁶ considered the adequacy of an insurer's conditional reservation of rights. The *American Motorists* insurer, AMICO, attempted to reserve its right to recover its defense costs by way of a letter stating that the insured's consent to the recovery was required. The insurer's reservation of rights letter provided: "For the time being, the Company will agree to defend reserving the right to seek reimbursement of defense costs in the event it were to be ultimately determined that there is no duty to defend and subject to the insured's agreement to such a reservation."¹⁴⁷ Further, AMICO asserted its conditional right to seek reimbursement only in its third reservation of rights letter; the company had previously sent two reservation of rights letters in which it did not raise its claimed right to reimbursement.¹⁴⁸

The insured contended that AMICO was not entitled to reimbursement of its defense costs because its third reservation of rights letter did not create the contractual understanding necessary to permit reimbursement.¹⁴⁹ The *American Motorists* court agreed with the insured. The court found that the requisite contractual understanding was lacking first because AMICO did not reserve its right to reimbursement until its third letter, and second because the right to reimbursement was conditioned on the insured's consent.¹⁵⁰ There was no showing that the insured had consented to AMICO's conditional reservation.¹⁵¹

AMICO argued that it was entitled to reimbursement because it had adequately reserved its right to seek reimbursement and because the insured had accepted the defense. The court responded by pointing out that while the insured may have accepted the defense, it did not agree to AMICO's reimbursement.¹⁵² While the insured did allow AMICO to pay its defense costs, AMICO began paying defense costs *before* it sent the subject reservation of rights letter.¹⁵³ It could not be said, therefore,

P.2d 236 (Cal. 1995), *review dismissed and cause remanded*, 906 P.2d 1 (1995). As noted previously, however, this Article does not discuss all California cases. Neither *Richardson* nor *Gossard* add anything to this discussion and both cases lack precedential value because of their subsequent history.

146. 24 Cal. Rptr. 2d 106 (Ct. App. 1993), *disapproved by* *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997).

147. *Id.* at 114 (quoting AMICO's reservation of rights letter).

148. *See id.*

149. *See id.*

150. *See id.*

151. *See id.*

152. *See id.*

153. *See id.*

that the insured had acquiesced to AMICO's defense under reservation. The *American Motorists* court thus reversed the trial court's judgment reimbursing AMICO's defense costs.¹⁵⁴

2. Conclusion

California courts recognized an insurer's right to the reimbursement of its costs associated with the defense of an uncovered suit, or uncovered claims in a mixed action, before the Supreme Court of California decided *Buss*. Three general statements can be made about insurer's right to reimbursement before 1997. First, insurers' right to reimbursement of defense costs was not based on the principle of restitution.¹⁵⁵ The right to reimbursement was instead contractual, which leads to a second general statement: the right to reimbursement hinged on the parties' agreement or understanding that the insurer had such a right.¹⁵⁶ Absent such agreement or understanding by the insured, the insurer had no right to reimbursement.¹⁵⁷ Third, in order to establish the requisite agreement or understanding, insurers had to clearly assert their rights to reimbursement in timely and unconditional reservation of rights letters.¹⁵⁸

B. Boarding the Buss

In *Buss v. Superior Court*,¹⁵⁹ the Supreme Court of California raised and answered four questions: First, may an insurer seek reimbursement of defense costs from its insured? As to claims that are not even potentially covered under its policy, yes; as to claims that are potentially covered, no.¹⁶⁰ Second, for what specific costs may an insurer be reimbursed? Those that can be allocated to claims that are not even potentially covered.¹⁶¹ Third, who bears the burden of proof when an

154. See *id.* at 114-15.

155. See *Reliance Ins. Co. v. Alan*, 272 Cal. Rptr. 65, 69 (Ct. App. 1990); *Travelers Ins. Co. v. Leshner*, 231 Cal. Rptr. 791, 809-10 (Ct. App. 1986).

156. See *Omaha Indem. Ins. Co. v. Cardon Oil Co.*, 687 F. Supp. 502, 504 (N.D. Cal. 1988), *aff'd*, 902 F.2d 40 (9th Cir. 1990); *St. Paul Mercury Ins. Co. v. Medical Lab. Network, Inc.*, 690 F. Supp. 901, 904 (C.D. Cal. 1988); *American Motorists Ins. Co. v. Allied-Sysco Food Servs., Inc.*, 24 Cal. Rptr. 2d 106, 114 (Ct. App. 1993); *Insurance Co. of the W. v. Haralambos Beverage Co.*, 241 Cal. Rptr. 427, 434 (Ct. App. 1987).

157. See, e.g., *State Farm Fire & Cas. Co. v. Thomas*, 756 F. Supp. 440, 445-46 (N.D. Cal. 1991); *American Motorists*, 24 Cal. Rptr. 2d at 114.

158. See, e.g., *Wallbrook Ins. Co. v. Goshgarian & Goshgarian*, 726 F. Supp. 777, 781-84 (C.D. Cal. 1989); *Omaha Indemnity*, 687 F. Supp. at 504-505; *St. Paul Mercury*, 690 F. Supp. at 904.

159. 939 P.2d 766 (Cal. 1997).

160. See *id.* at 768.

161. See *id.* at 768-69.

insurer seeks reimbursement? The insurer bears the burden of proof.¹⁶² Fourth, what is the insurer's burden? The insurer must establish its right to reimbursement by a preponderance of the evidence.¹⁶³

Plaintiff H & H Sports, Inc. (H & H) sued professional sports magnate Jerry Buss and some of his related entities alleging twenty-seven causes of action. Buss tendered the H & H action to his various insurers. All of the insurers except Transamerica refused to defend, denying coverage.¹⁶⁴

Transamerica accepted the defense of the H & H action because among the plaintiff's twenty-seven causes of action was a single count alleging defamation. The plaintiff's defamation claim was potentially within the personal injury coverage of Buss's two general liability policies with Transamerica.¹⁶⁵ In agreeing to defend Buss, Transamerica reserved its right to deny coverage. "With respect to defense costs incurred or to be incurred in the future," the insurer specifically reserved its rights to be reimbursed for those fees or to obtain an allocation of fees and expenses should it be determined that there was no coverage.¹⁶⁶ Transamerica then agreed to pay on Buss's behalf the cost of independent counsel, inasmuch as the conflict of interest posed by its reservation of rights prevented the employment of its regular defense counsel.¹⁶⁷

Buss responded to Transamerica's reservation of rights with his own reservation rights. The parties then entered into an agreement, supported by consideration, that provided for Buss to reimburse Transamerica for the appropriate pro rata share of defense fees and costs should a court order such allocation.¹⁶⁸ Transamerica would ultimately spend over \$1,000,000 defending Buss, with the cost of defending the defamation count falling somewhere between \$21,720 and \$55,767.50 according to an expert hired by Transamerica.¹⁶⁹

Buss settled the H & H action for \$8.5 million. Transamerica refused to contribute to the settlement. Buss then sued the insurer for breach of contract, bad faith, and declaratory relief.¹⁷⁰ Transamerica cross-

162. *See id.* at 769.

163. *See id.*

164. *See id.*

165. *See id.* at 770.

166. *Id.*

167. *See id.*

168. *See id.*

169. *See id.*

170. *See id.* at 770-71.

claimed, asserting that it did not owe coverage, that it was not obligated to contribute to the settlement, and that it was entitled to be reimbursed for its defense costs in an amount to be proved at trial.¹⁷¹

Transamerica moved for summary judgment on Buss's complaint and won. Buss in turn moved for summary judgment on Transamerica's cross-claim for reimbursement.¹⁷² The trial court denied Buss's motion and he filed a petition for a writ of mandamus in the appropriate court of appeal. The court of appeal denied a peremptory writ¹⁷³ and Buss petitioned the supreme court for review.¹⁷⁴

The supreme court necessarily had to address liability insurers' duty to defend and it had to do so in the context of a mixed action, in which some of the claims are at least potentially covered and others are not.¹⁷⁵ The *Buss* court allowed that an insurer must defend a mixed action in its entirety, but it could not justify that position as a matter of contract law.

We cannot justify the insurer's duty to defend the entire "mixed" action contractually, as an obligation arising out of the policy, and have never even attempted to do so. To purport to make such a justification would be to hold what we cannot—that the duty to defend exists, as it were, in the air, without regard to whether or not the claims are at least potentially covered. . . . [T]he duty to defend goes to any action seeking damages for any covered claim. If it went to an action *simpliciter*, it could perhaps be taken to reach the action *in its entirety*. But it does not. Rather, it goes to an action *seeking damages for a covered claim*. It must therefore be read to embrace the action *to the extent that it seeks such damages*. So read, it accords with the general rule, . . . that the insurer has a duty to defend as to the claims that are at least potentially covered, but not as to those that are not Even if [a] policy's language were unclear, [a] hypothetical insured could not have an objectively reasonable expectation otherwise.¹⁷⁶

The court justified an insurer's duty to defend a mixed action in its entirety as a prophylactic measure imposed as a matter of law in support of the policy. "To defend immediately," as it must, "an insurer has to defend entirely." It cannot parse the claims, dividing those that are at least potentially covered from those that are not."¹⁷⁷ As to claims that are at least partially covered, the insurer gives and the insured gets the funded defense for which they bargained.¹⁷⁸ As to those claims that are not even potentially covered, however, the insurer may give and the insured may get much more than they bargained for if the defense of the

171. See *id.* at 771.

172. See *id.*

173. *Buss v. Superior Court*, 50 Cal. Rptr. 2d 447 (Ct. App.), review granted and *op. superseded*, 917 P.2d 1165 (Cal. 1996), *aff'd*, 939 P.2d 766 (1997).

174. See *Buss*, 939 P.2d at 772.

175. See *id.* at 774-75.

176. *Id.* at 775 (citations omitted) (emphasis in original).

177. *Id.*

178. See *id.*

uncovered claims necessitates additional costs.¹⁷⁹

Turning then to an insurer's right to seek reimbursement for its defense costs in a mixed action, the *Buss* court held that an insurer may not seek to recover defense costs attributable to claims that are at least potentially covered.¹⁸⁰ "With regard to defense costs for these claims, the insurer has been paid premiums by the insured. It bargained to bear these costs. To attempt to shift them would upset the arrangement."¹⁸¹ That would not be the case if the policy at issue provided for reimbursement, nor would it be the case if the parties entered into a separate agreement supported by separate consideration. In the first instance the policy would qualify itself, and in the second the separate contract would supersede the policy pro tanto.¹⁸² Apart from these two exceptions, an insurer may not seek the reimbursement of defense costs associated with potentially covered claims.

Where a third-party's claims are at least potentially covered, an insurer cannot have a right of reimbursement implied in fact in the policy, inasmuch as it bargained for such defense costs.¹⁸³ Nor does the insurer have a right to reimbursement implied in law. Under the law of restitution, this sort of right "runs against the person who benefits from 'unjust enrichment'" and favors the person who would suffer a loss as a result.¹⁸⁴ If an insured is "'enriched'" by the insurer bearing the defense costs for which it bargained, the insurer's burden is consistent with its contractual obligation under its policy and the enrichment therefore cannot be deemed unjust.¹⁸⁵

As to claims that are not even potentially covered, however, an insurer is entitled to seek reimbursement from the insured for its defense costs.¹⁸⁶ An insurer has no duty to defend its insured against such claims. The insurer has not been paid premiums for these defense costs and it did not bargain to bear them.¹⁸⁷ To attempt to shift such costs would not upset the parties' arrangement.¹⁸⁸ Whether or not the insurer

179. *See id.*

180. *See id.*

181. *Id.*

182. *See id.* at 776.

183. *See id.*

184. *Id.*

185. *Id.*

186. *See id.*

187. The *Buss* court cited no authority to support this proposition and it may not in fact be true. *See Quinn, supra* note 75, at 33.

188. *See Buss*, 939 P.2d at 776.

has a contractual right of reimbursement that is implied in fact in the policy, it has a quasi-contractual right of reimbursement that is implied as a matter of law.¹⁸⁹ The court again looked to the law of restitution for support:

[U]nder the law of restitution such a right runs against the person who benefits from “unjust enrichment” and in favor of the person who suffers loss thereby. The “enrichment” of the insured by the insurer through the insurer’s bearing of unbargained-for defense costs is inconsistent with the insurer’s freedom under the policy and therefore must be deemed “unjust.” It is like the case of *A* and *B*. *A* has a contractual duty to pay *B* \$50. He has only a \$100 bill. He may be held to have a prophylactic duty to tender the note. But he surely has a right, implied in law if not in fact, to get back \$50.¹⁹⁰

Even if the policy’s language is unclear, the insured could not have an objectively reasonable expectation that it is entitled to the windfall that it would receive via the defense of clearly uncovered claims.¹⁹¹

The court also reasoned that giving insurers a right of reimbursement made good practical sense.¹⁹² Without a right of reimbursement, an insurer might be tempted to refuse to defend a mixed action—especially one in which uncovered claims predominate. With a right of reimbursement, the insurer faces no such temptation, for it rests secure in the knowledge that it can recover any additional costs associated with the uncovered claims.¹⁹³

The second question for the court was, in a mixed action, what specific costs may an insurer recover from the insured?¹⁹⁴ The answer, logically, is those defense costs that may be allocated solely to those claims that are not even potentially covered.

The reason is this. It is as to defense costs that can be allocated solely to the claims that are not even potentially covered that the insurer has not been paid premiums by the insured. By contrast, the insurer has in fact been paid as to costs that can be allocated solely to the claims that are at least potentially covered. So too as to costs that can be allocated jointly to the claims that are at least potentially covered and to those that are not—¹⁹⁵by definition, these costs are fully attributable to the former as well as the latter.

The third question for the court dealt with the burden of proof. Quite simply, when an insurer seeks the reimbursement of its costs defending uncovered claims in a mixed action, which party bears the burden of

189. *See id.*

190. *Id.* at 776-77.

191. *See id.* at 177.

192. *See id.* at 778.

193. *See id.*

194. *See id.*

195. *Id.* (footnote omitted).

proof?¹⁹⁶ The *Buss* court held that the insurer bears the burden of proof because it is the party seeking relief. The court saw no reason to depart from such basic evidence law.¹⁹⁷

The fourth and final question asked of the court was, in an action for reimbursement, what is the insurer's burden of proof?¹⁹⁸ Again tracking basic evidence law, the court held that an insurer must establish its right to reimbursement by a preponderance of the evidence.¹⁹⁹ In so holding, the court rejected *Buss*'s argument that the insurer's burden should be one of "undeniable evidence."²⁰⁰

Analyzing *Buss* in light of prior California law, it is obvious that the supreme court's most significant pronouncement was an insurer's right to recovery grounded in the law of restitution and the threat of unjust enrichment to the insured.²⁰¹ In doing so, the *Buss* court rejected the reasoning first announced in *Leshner*²⁰² that an insurer has no right to restitution because by defending a mixed action, it confers a benefit on the insured only incidental to the insurer's own duty, and only out of its desire to protect its own interests.²⁰³ In other words, an insurer defends under a reservation of rights not to benefit the insured, but to protect itself from a subsequent breach of contract claim.²⁰⁴ The insured's benefit from a conditional defense is but a nice secondary effect.

The *Buss* court rejected the *Leshner* reasoning hostile to restitution because it turns on motive, which is notoriously hard to discern.²⁰⁵ The attribution of motive is especially difficult where, as in the case of an insurance company, any heart or mind from which motive might flow is purely fictitious.²⁰⁶ The supreme court, therefore, avoided any consideration of "why the insurer acts as it does subjectively, [and] merely look[ed] to what results from its action objectively."²⁰⁷ The court explicitly disapproved *Leshner* and other decisions in which courts

196. *See id.*

197. *See id.*

198. *See id.*

199. *See id.*

200. *See id.* at 779-84.

201. *See id.* at 775-78.

202. *Travelers Ins. Co. v. Leshner*, 231 Cal. Rptr. 791 (Ct. App. 1986), *disapproved* by *Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997).

203. *See id.* at 809-10.

204. *See id.*

205. *See Buss*, 939 P.2d at 777 n.14.

206. *See id.*

207. *Id.* at 777-78 n.14.

took the same approach.²⁰⁸

C. Other States' Approaches

Insurers' right to recover costs incurred in the defense of uncovered claims or causes of action was an issue outside California before *Buss*, and it likely will be a bigger issue now. The decisions from other states track California law before *Buss*.

1. Cases

The Ninth Circuit analyzed liability insurers' right to reimbursement under Nevada law in *Forum Insurance Co. v. County of Nye*.²⁰⁹ In *County of Nye*, the district court ruled in Forum's favor at summary judgment, holding that the insurer had no duty to defend or indemnify the County in the underlying action, and that the County was obligated to reimburse Forum for its defense expenses.²¹⁰ The County appealed.

Concerning Forum's right to reimbursement, the insurer had "unilaterally, but explicitly" reserved its right to seek reimbursement in a timely reservation of rights letter.²¹¹ Although the County objected to Forum's reservation, it accepted a defense valued "at hundreds of thousands of dollars" after the insurer reserved its rights.²¹² The County insisted that its objection to Forum's reservation of rights defeated the argument that by accepting the benefits of the defense the County had validated the reservation. The Ninth Circuit disagreed.²¹³

Under the rule the County proposed, an insured could deny the insurer's ability to recoup significant costs merely by objecting to a reservation of rights. The insurer would thus be required to withhold its defense in order to protect its own interests.²¹⁴ "Such a result would benefit no one."²¹⁵ Following this course would prejudice the insured in the third-party action, would potentially expose the insurer to other liability, and would foster additional litigation. The better course is to allow an insurer to reserve its rights in the manner least damaging to both parties, so long as the insured clearly knows that it may later be

208. *See id.* at 778 n.14.

209. No. 91-16724, 1994 WL 241384 (9th Cir. June 3, 1994). This is an unpublished disposition. The decision of the Court is referenced in a "Table of Decisions Without Reported Opinions" appearing in the Federal Reporter. *See* *Forum Ins. Co. v. County of Nye*, 26 F.3d 130 (9th Cir. 1994).

210. *See County of Nye*, 1994 WL 241384, at *1-2.

211. *Id.* at *2.

212. *Id.*

213. *See id.*

214. *See id.* at *3.

215. *Id.*

held responsible for defense costs allocated to uncovered claims.²¹⁶

The court and the parties embraced California law in resolving the issues presented.²¹⁷ The *County of Nye* court affirmed the district court's reimbursement of defense expenses incurred after Forum expressly reserved its rights. The County could not refuse Forum's defense under reservation yet retain the related benefits. There was sufficient evidence of an understanding between the parties that Forum would be reimbursed for its defense costs.²¹⁸

California law guided a Minnesota federal court in *Knapp v. Commonwealth Land Title Insurance Co.*²¹⁹ In *Knapp*, plaintiff Robert Knapp obtained a title insurance policy from Commonwealth for land that he purchased from a bankruptcy estate. Knapp's title to the land was subsequently contested. Commonwealth accepted Knapp's tender of defense, but did so under a reservation of rights. The insurer specifically reserved its right to seek reimbursement of its attorneys' fees and costs if coverage were later denied.²²⁰ Commonwealth's reservation of rights letter provided:

[T]his claim will be subject to a reservation of rights in favor of Commonwealth Land Title Insurance Company . . . [I]t should be distinctly understood that no action by Commonwealth heretofore or hereinafter taken in this matter is to be construed in any way as a waiver of our right to later disclaim liability in the event it comes to light that Commonwealth has provided a defense for matters excluded from Policy coverage . . . Commonwealth reserves the right to deny the claim, discontinue payment of outside counsel and seek reimbursement from you for counsel fees and costs incurred by the Company by reason of the claim subsequently found not to be within Policy coverage.²²¹

Knapp did not respond to the reservation of rights letter.²²²

Commonwealth proceeded to defend Knapp and the case was lost. The district court granted Commonwealth's motion for summary judgment against Knapp, holding that its policy did not cover the claim. Commonwealth then sought reimbursement of the roughly \$28,000 in attorney's fees and costs it incurred defending Knapp.²²³

Knapp argued that because parts of the claims asserted against him

216. *See id.*

217. *See id.* at *2-3.

218. *See id.* at *3.

219. 932 F. Supp. 1169 (D. Minn. 1996).

220. *See id.* at 1170.

221. *Id.* (ellipses in original).

222. *See id.* at 1172.

223. *See id.* at 1170.

arguably fell within the scope of Commonwealth's policy, Commonwealth had a duty to defend him and was not entitled to reimbursement.²²⁴ The court succinctly rejected Knapp's argument regarding the existence of a duty to defend. But the determination that it did not owe Knapp a defense did not necessarily entitle Commonwealth to the reimbursement of its defense costs.²²⁵ There being no Minnesota law on point, the *Knapp* court looked to California law governing liability insurers' right to reimbursement.²²⁶

Knapp offered the court little to dissuade it from recognizing an insurer's right to reimbursement of defense costs under certain circumstances. The court determined that California law was persuasive and was consistent with Minnesota law surrounding the duty to defend.²²⁷ Addressing the underpinnings of insurers' right to reimbursement, the court wrote:

[C]ourts should be consistent in encouraging insurance companies to properly meet their duty to defend [their] insured[s] against third party claims and minimize unnecessary claims to enforce policy coverage. However, where an insurer has properly met its duty and subsequently successfully challenges policy coverage, it should be entitled to the full benefit of such a challenge and be reimbursed for the benefits it bestowed, in good faith, to its insured.²²⁸

The remaining question for the court was whether Commonwealth's reservation of rights letter adequately notified Knapp of his possible liability for defense costs, thus properly reserving Commonwealth's right to reimbursement.²²⁹ The *Knapp* court concluded that Commonwealth adequately reserved its right to reimbursement and clearly indicated that possibility to Knapp.²³⁰ Under those circumstances, Knapp's silence in response to Commonwealth's reservation and his subsequent acceptance of the defense provided by Commonwealth constituted his implied agreement to the reservation of rights.²³¹

Colorado courts apparently embrace insurers' right to reimbursement, although the issue has never been fully litigated. In *Hecla Mining Co. v. New Hampshire Insurance Co.*,²³² the Colorado Supreme Court stated that in cases of questionable coverage:

224. *See id.* at 1171.
225. *See id.*
226. *See id.* at 1171-72.
227. *See id.* at 1172.
228. *Id.*
229. *See id.*
230. *See id.*
231. *See id.*
232. 811 P.2d 1083 (Colo. 1991).

The appropriate course of action for an insurer who believes that it is under no obligation to defend, is to provide a defense to the insured under a reservation of its rights to seek reimbursement should the facts at trial prove that the incident resulting in liability was not covered by the policy, or to file a declaratory judgment action after the underlying case has been adjudicated.²³³

The *Hecla Mining* court did not cite California authority to support its position.²³⁴

Another Colorado appellate court recognized insurers' right to reimbursement in *Horace Mann Insurance Co. v. Peters*.²³⁵ The *Horace Mann* court relied on the insured's contingent liability to the insurer for the reimbursement of defense costs in determining that the settlement of the underlying tort action did not render a pending declaratory judgment action moot.²³⁶ In doing so, the court reiterated the requirement that an insurer seeking reimbursement of defense costs must have reserved its right to do so.²³⁷

A Colorado federal court spoke on the issue in cursory fashion in *First Federal Savings and Loan Ass'n v. Transamerica Title Insurance Co.*²³⁸ In *First Federal*, the court stated simply that an insurance company "may also reserve its right to deny its duty to defend and later recover for any attorney fees paid,"²³⁹ citing *Walbrook Insurance Co. v. Goshgarian & Goshgarian*²⁴⁰ and *Omaha Indemnity Insurance Co. v. Cardon Oil Co.*²⁴¹ for support. The *First Federal* court did nothing with that statement and it is difficult to tell whether it even applied that principle of law to the facts at bar.²⁴²

2. Conclusion

There is nothing in *County of Nye, Knapp, Hecla Mining, Horace Mann* or *First Federal* to suggest that those courts would have strayed from the California reimbursement path before *Buss*. The *County of*

233. *Id.* at 1089.

234. *See id.* at 1089-90.

235. 948 P.2d 80 (Colo. Ct. App. 1997).

236. *See id.* at 84-85.

237. *See id.* at 84.

238. 793 F. Supp. 265 (D. Colo. 1992), *aff'd*, 19 F.3d 528 (10th Cir. 1994).

239. *Id.* at 269.

240. 726 F. Supp. 777, 781-82 (C.D. Cal. 1989).

241. 687 F. Supp. 502, 505 (N.D. Cal. 1988), *aff'd*, 902 F.2d 40 (9th Cir. 1990).

242. *See First Federal*, 793 F. Supp. at 270 (holding that insurer was entitled to recover its costs, but not distinguishing between costs typically awarded to prevailing party at summary judgment and defense costs to be reimbursed).

Nye, Knapp and *First Federal* courts were guided by California law, and the *Hecla Mining* and *Horace Mann* courts adopted principles enunciated in California cases without express reference. It seems reasonable, then, to anticipate or expect that *Buss* will likewise influence law beyond California's borders.

IV. THE RIGHT TO REIMBURSEMENT EXAMINED

Insurers' right to recoup their costs incurred defending uncovered claims from their insureds is a controversial topic. Policyholders and their counsel quite naturally believe that insurers' right to reimbursement of defense costs devalues liability insurance.²⁴³ Insurers, on the other hand, contend that they did not bargain to defend uncovered claims and that insureds should not receive a benefit for which they did not pay premiums.²⁴⁴

A. Policyholders' Perspective

At a visceral level, policyholders fear that recognizing a right of reimbursement nullifies the duty to defend.

Only by subordinating the duty to defend to the indemnity obligation in [a liability insurance] policy can one ever justify permitting a carrier to seek recoupment of defense costs it voluntarily incurred under a reservation of rights made after determining that there is at least a possibility of coverage under the policy. Taken to its logical extreme, the recoupment of defense costs would collapse the defense obligation, *i.e.*, if there is ultimately no indemnity obligation, the insurer should not have been required to pay ("front") the defense costs in the first place and ought to be able to get its money back.²⁴⁵

There is at least one basic problem with this appealing argument. That is, the defense nullification argument appears to turn on insureds' belief that insurers' contractual obligation to defend even groundless, false or fraudulent suits includes a promise to defend "questionably covered claims."²⁴⁶ As noted previously, however, insurers' duty to defend even baseless or meritless suits does not mean that insurers are contractually bound to defend uncovered causes of action.²⁴⁷ Insurers' duty to defend mixed actions in their entirety is a prophylactic obligation imposed by law, not an obligation arising out of their policies.²⁴⁸

243. See, *e.g.*, *Johnson*, *supra* note 2, at 254.

244. See generally *Buss v. Superior Court*, 939 P.2d 766, 775-76 (Cal. 1997).

245. *Johnson*, *supra* note 2, at 254.

246. *Id.*

247. See *supra* notes 16-18 and accompanying text; see also Richard C. Giller, *A Further Explanation as to Why Insurers Are Entitled to Seek Reimbursement of Defense Costs*, 17 INS. LITIG. REP. 319, 320 (1995) [hereinafter *A Further Explanation*].

248. See *Buss*, 939 P.2d at 775.

Insurers are not entitled to recoup their defense costs attributable to uncovered claims or causes of action incurred before a negative coverage determination is made. The duty to defend can be extinguished only prospectively, not retroactively.²⁴⁹ An insurer must defend until it can be shown that no claim can in fact be covered under the policy.²⁵⁰ *Buss* does not change this rule.²⁵¹

Second, insureds argue that insurers cannot reserve their rights to seek reimbursement of defense costs. A reservation of rights is necessarily limited to the insurer's indemnity obligation based on the time that the duty to defend arises.

Since the duty arises at the outset of the potentially covered action and the defense determination made upon a comparison of the complaint and the policy provisions, there is no reason for a reservation in the first place; the duty to defend is ripe for decision. It is essentially nonsensical for an insurer to state that, while it has all of the facts necessary to make a determination of the duty to defend, it wishes to reserve its right to later renege on [that] initial determination²⁵²

Moreover, insurers have no policy right to seek the reimbursement of defense costs; accordingly, there is no right to reserve.²⁵³

The term "reservation of rights" arguably is a misnomer when it comes to reimbursing defense costs. Only an antecedent right can be reserved; an insurer cannot use a reservation of rights letter to create new contractual rights. With respect to the reimbursement of defense costs, then, a reservation of rights letter might be better described as a "reservation of claims" letter.²⁵⁴

At the outset, this argument fails miserably when applied to mixed actions. An insurer defending a mixed action under reservation has most certainly determined that it has no duty to defend specified claims, but the law obligates it to defend the entire action anyway. An insurer that defends a mixed action under reservation and later seeks the reimbursement of its defense costs attributable to uncovered claims is reneging on nothing. This argument also ignores the point that an insurer's duty to defend can only be extinguished prospectively. If an

249. *See id.* at 773.

250. *See id.*

251. *See id.*

252. Johnson, *supra* note 2, at 255 (footnote omitted).

253. *See id.*

254. I am grateful to Professor Robert H. Jerry, II, a leading insurance law scholar, who suggested this description in casual conversation.

insurer defends until it is determined that there is no duty to do so under any theory, it has fulfilled its contractual obligation. The insured has received all the defense to which it was entitled. Again, the insurer has reneged on nothing.

To the extent this argument assumes (or at least implies) that an insurer cannot recoup defense costs because it did not expressly provide for possible reimbursement in its policy, it again fails. The fact that a policy does not grant the insurer a right to reimbursement does not render the contract incomplete. The policy provides that the insurer will defend only to the extent of its coverage. If an insurer truly is entitled to the reimbursement of its defense costs attributable to a particular claim, logic and law dictate that there was no duty to defend that claim in the first place. The insured was not contractually entitled to the benefit of a defense. Recognizing a right to reimbursement thus ensures that an insured gets only the benefits for which its policy provides.²⁵⁵

Furthermore, an insurer that asserts its right to reimbursement in a reservation of rights letter is not creating that right in its correspondence. A reservation of rights letter, though perhaps misnamed in this context, serves as a demand for reimbursement on the insured.²⁵⁶ In some states recognizing an insurer's quasi-contractual right to reimbursement, such a demand may be a prerequisite to recovery.²⁵⁷

It is also possible that the insurer's right to reimbursement is "implied in fact in the policy as contractual."²⁵⁸ If so, a reservation of rights letter is not misnamed in this context. An insurer must reserve its right to reimbursement to avoid waiving its right,²⁵⁹ or to avoid the loss of its right via estoppel.

Third, allowing insurers to recover their defense costs attributable to uncovered claims will spawn considerable new litigation as insurers attempt to enforce their rights.²⁶⁰ History does not support this argument. Insurers' right to reimbursement has existed for more than a decade, yet there are few reported cases on the subject.²⁶¹ Insurers have a right to reimbursement only where defense costs can be allocated solely to claims that are not even potentially covered.²⁶² In many cases it is not feasible to allocate defense costs between covered and

255. See *Buss*, 939 P.2d at 776; *A Further Explanation*, *supra* note 247, at 320.

256. See *Buss*, 939 P.2d at 784 n.27.

257. See *id.*

258. *Id.*

259. See *id.*

260. See *id.* at 781 (discussing this argument in connection with burden of proof).

261. See *supra* notes 87-242, and accompanying text.

262. See *Buss*, 939 P.2d at 781.

uncovered claims.²⁶³ Additionally, insurers pursue reimbursement only in exceptional cases. Beyond the threshold requirement that defense costs subject to reimbursement are strictly limited to clearly uncovered claims, insurers will as a matter of simple economics pursue reimbursement only where defense costs are substantial.²⁶⁴ The defense costs subject to recovery must be great enough to justify to the insurer the cost of the related litigation. Further, the insured must have the financial resources to reimburse the defense costs sought;²⁶⁵ it would be pointless for an insurer to spend money litigating a right without economic benefit.

It might reasonably be argued that an insurer's implied duty of good faith and fair dealing prevents it from suing an insured to recover defense costs where the insured does not have the financial resources to pay those costs.²⁶⁶ An insurer that knows or should know that its insured cannot reasonably reimburse the defense costs at issue, but that still pursues the matter to judgment, clearly harms the insured.²⁶⁷ Such conduct certainly bears the dress of bad faith, keeping in mind the varying bad faith standards between states.²⁶⁸ It may be an act of bad

263. See, e.g., *Gibson v. Farm Family Mut. Ins. Co.*, 673 A.2d 1350, 1354 (Me. 1996).

264. See *Buss*, 939 P.2d at 781.

265. See *id.*

266. The duty of good faith and fair dealing is implied in all contracts. It is undisputed that insurance policies, like all other contracts, are subject to this implied duty. See *Vaughan v. McMinn*, 945 P.2d 404, 406 (Colo. 1997); *Best Place, Inc. v. Penn Am. Ins. Co.*, 920 P.2d 334, 337-39 (Haw. 1996); *Pavia v. State Farm Mut. Auto. Ins. Co.*, 626 N.E.2d 24, 27 (N.Y. 1993); *Swanson v. Sioux Valley Empire Elec. Ass'n*, 535 N.W.2d 755, 758 (S.D. 1995); *Austin Co. v. Royal Ins. Co.*, 842 S.W.2d 608, 610 (Tenn. Ct. App. 1992); *Levine v. Selective Ins. Co. of Am.*, 462 S.E.2d 81, 84 (Va. 1995).

267. The judgment may impair the insured's credit, or it may disrupt various business or financial relationships or opportunities.

268. In order to breach its implied duty of good faith and fair dealing, an insurer must do more than simply breach its contract with the insured. As the Arkansas Supreme Court observed in *First Marine Insurance Co. v. Booth*, 876 S.W.2d 255 (Ark. 1994), "[t]o be liable for bad faith the insurer must engage in affirmative misconduct, without a good faith defense, in a malicious, dishonest, or oppressive attempt to avoid liability." *Id.* at 257; accord *Zurich Ins. Co. v. Mitchell*, 712 S.W.2d 340, 343 (Ky. 1986); *Commercial Union Ins. Co. v. Liberty Mut. Ins. Co.*, 393 N.W.2d 161, 164 (Mich. 1986). This high standard is not universal, however. Several states allow bad faith recovery for an insurer's simple negligence. See, e.g., *Indiana Ins. Co. v. Plummer Power Mower & Tool Rental, Inc.*, 590 N.E.2d 1085, 1093 (Ind. Ct. App. 1992); *Hartford Cas. Ins. Co. v. New Hampshire Ins. Co.*, 628 N.E.2d 14, 17 (Mass. 1994); *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312, 314 (Tex. 1994); *Shamblin v. Nationwide Mut. Ins. Co.*, 396 S.E.2d 766, 776 (W. Va. 1990).

faith by the insurer merely to subject the insured to the expense of litigation where ultimate recovery is unlikely.

Fourth, allowing insurers a right to reimbursement may chill insureds' zealous defense.²⁶⁹ This chill may emanate from defense counsel's fear that a zealous defense increases fees and expenses; hence, the less the defense attorney does the better off the insured will be in the long run. Alternatively, the insured may restrain defense counsel in order to hold down legal fees and reduce its potential liability to the insurer in a subsequent action for reimbursement. The insured's defense suffers in either instance.

It seems unlikely that defense attorneys selected by insurers will allow the potential for reimbursement to impair their defense of insureds. A defense attorney's obligations to an insured exist independent of the insurance policy and of the relationship between the insurer and the insured.²⁷⁰ The threat of reimbursement, no matter how certain, does not alter the defense attorney's ethical duties to the insured. The defense attorney remains free to represent the insured as he sees fit.²⁷¹

If the insured chooses to restrain appointed defense counsel or its chosen counsel, thereby chilling its own defense, so be it. Insureds are free to make such economic choices. The fact that a bare bones defense may increase the insured's personal exposure on uncovered claims may make the insured's choice unwise, but it does not make it impermissible.

The final argument to be made against insurers' claimed right to reimbursement was advanced by Justice Kennard in his dissent in *Buss*.²⁷² The basic thrust of Justice Kennard's argument is that liability insurance policies expressly obligate insurers to defend *suits* rather than *claims*, such that the duty to defend entire actions necessarily encompasses uncovered claims.²⁷³ This approach logically reflects insurers' right to control the defense of litigation against their insureds.²⁷⁴ That is, by accepting the defense of claims that are not even potentially covered, an "insurer acquires a freer hand and enhanced control in the defense of those claims that are potentially covered."²⁷⁵ In this way the insurer gains control over its potential indemnity

269. See *Buss*, 939 P.2d at 781-82 (discussing this potential threat in connection with insurers' burden of proof in reimbursement actions).

270. See *Rogers v. Robson, Masters, Ryan, Brumund & Belom*, 407 N.E.2d 47, 49 (Ill. 1980); *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 269 (Miss. 1988); *State Farm Fire & Cas. Co. v. Mabry*, 497 S.E.2d 844, 847 (Va. 1998).

271. See *Buss*, 939 P.2d at 782.

272. See *id.* at 784-87 (Kennard, J., dissenting).

273. See *id.* at 786-87.

274. See *id.* at 785.

275. *Id.*

exposure.²⁷⁶

This is a powerful argument insofar as it focuses on standard policy language obligating insurers to defend “suits.” That portion of Justice Kennard’s thesis is difficult to refute. The argument begins to unravel, however, when tied to insurers’ right to control the defense of mixed actions. If, in a mixed action, counsel hired by the insurer to defend the insured can influence coverage through his conduct of the defense (as is often the case),²⁷⁷ the insured is entitled to independent counsel at the insurer’s expense.²⁷⁸ The “logical quid pro quo”²⁷⁹ that Justice Kennard sees as requiring the insurer’s defense of some uncovered claims in an entire action in exchange for the right to global control of the defense no longer exists. The focus then returns to coverage, and the necessary link between coverage and the duty to defend upon which the *Buss* majority seized.

In summary, none of the arguments against recognizing insurers’ right to reimbursement of defense costs attributable to clearly uncovered claims are compelling when closely scrutinized. Even Justice Kennard’s very fine argument in his dissent in *Buss* has its problems. Insurers’ right to reimbursement thus assumed, the focus shifts to the nature and extent of that right. And, if an insurer does not have a right to reimbursement in a given case or in a particular set of circumstances, how is it that the right did not attach?

B. Insurers’ Perspective

Insurers quite naturally believe that they should be reimbursed for their defense of uncovered claims. *Buss* lends insurers great support. But how does an insurer’s right to reimbursement come about? Once created, how might the right be limited?

First, an insurer might grant itself a contractual right to reimbursement in its policy. Although standard liability policies do not include such provisions, nothing prevents an insurer from crafting a manuscript policy

276. *See id.*

277. *See* Douglas R. Richmond, *Walking a Tightrope: The Tripartite Relationship Between Insurer, Insured, and Insurance Defense Counsel*, 73 NEB. L. REV. 265, 273 (1994) (“Defense counsel can often steer a case toward a coverage result favorable to the insurer. For example, a defense attorney may elicit deposition testimony supporting a coverage defense.”).

278. *See generally* *Lost in the Eternal Triangle*, *supra* note 70, at 485-92.

279. *Buss*, 939 P.2d at 785 (Kennard, J., dissenting).

that expressly confers a right to reimbursement.²⁸⁰ An insurer that employs manuscript policies expressly conferring a right to reimbursement should prevail over an insured who argues that the attempted recovery of defense costs deprives him of the benefit of his bargain, or constitutes an effort by the insurer to renege on its contractual obligation.²⁸¹ The insured agreed to the insurer's right to reimbursement when he purchased the policy. An insured that does not want to subject itself to potential reimbursement claims can purchase a policy from another insurer that does not include such a provision.

Second, an insurer that wants a right to reimbursement might strike a separate agreement with its insured. Such an agreement would have to be supported by adequate consideration.²⁸² For example, an insurer and insured might agree that in exchange for the insured's promise to reimburse the insurer's defense costs attributable to clearly uncovered claims, the insurer will waive the insured's deductible or self-insured retention.

Third, and most likely, insurers' right to reimbursement may be implied in law.²⁸³ The law implies this right to prevent insureds' unjust enrichment. An insurer's action to recoup defense costs clearly attributed to uncovered claims is therefore one for restitution, as the *Buss* court recognized.²⁸⁴

1. *The Law of Restitution*

"Restitution," which means restoration, is a difficult subject.²⁸⁵ The term is broadly used to refer to "the law of nonbargained benefits."²⁸⁶ Restitution is not a cause of action, but a general description of the relief afforded a successful plaintiff.²⁸⁷ It may be sought in tort actions and contract actions, and it may be sought either in law or in equity.²⁸⁸ Because it is a remedy, restitution can be employed in any case in which it is appropriate.²⁸⁹ Restitution is intended to remedy unjust enrichment.

The general principle of restitution may be stated as follows: "A person who receives a benefit by reason of an infringement of another

280. A manuscript policy is written to include coverages, conditions or exclusions not found in a standard policy. See GLOSSARY OF INSURANCE TERMS 157 (Thomas A. Green, et. al., eds., 5th ed. 1994).

281. See *Buss*, 939 P.2d at 782.

282. See *id.* at 776.

283. See *id.*

284. See *id.* at 776-77.

285. See DAN B. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 4.1, at 222 (1973)

286. Saul Levmore, *Explaining Restitution*, 71 VA. L. REV. 65, 65 (1985).

287. See DOBBS, *supra* note 285, § 4.1, at 222.

288. See *id.* § 4.1, at 223.

289. See *id.*

person's interest, or of loss suffered by the other, owes restitution to him in the manner and amount necessary to prevent unjust enrichment."²⁹⁰ This definition makes clear that a defendant's duty to make restitution has a basis independent of strict rules of contract and tort. Indeed, a right to restitution may arise in cases in which no contractual obligation exists and no tort occurs.²⁹¹ Applying the elements of restitution to the defense of a mixed action, the benefit is the defense provided to the insured, the infringement or loss is the insurer's payment of the insured's defense in connection with uncovered claims, and the unjust enrichment to be avoided through restitution is the insured's receipt of a free defense against claims that are not covered under its policy.

Establishing the recipient's entitlement or right to the benefit conferred is a logical first step in restitution analysis. If the recipient is entitled or has a right to the benefit, he cannot be unjustly enriched by its receipt. Conversely, absent a right or entitlement, any enrichment may be unjust. It does not matter that the recipient gained the benefit honestly, for restitution is aimed not at compensating the plaintiff, but at compelling the defendant to disgorge benefits that in equity and good conscience he ought not keep.²⁹²

The recipient's lack of entitlement or right to the subject benefit, however, will not alone start courts or litigants down the path to restitution. If the benefits conferred do not *unjustly* enrich the recipient, the lack of entitlement or a right is inconsequential.²⁹³ As a general rule, a recipient is not unjustly enriched, and thus does not owe restitution, when the benefit was conferred by a "volunteer or intermeddler."²⁹⁴

This general rule disfavoring volunteers involves two distinct principles. First, one who confers a benefit upon another with the intention of making a gift has no claim for restitution against the recipient in the absence of duress, fraud, mistake or undue influence.²⁹⁵ The recipient of the benefit is enriched, but not unjustly so, for there is no injustice in retaining a gift freely given.²⁹⁶ This principle holds without regard for the form of the gift. For example, gratuitously

290. RESTATEMENT (SECOND) OF RESTITUTION § 1 (Tentative Draft No. 1, 1983) [hereinafter RESTATEMENT].

291. *See id.* § 1 cmt. a.

292. *See* DOBBS, *supra* note 285, § 4.1, at 224.

293. *See generally* RESTATEMENT, *supra* note 290, at § 1 cmt. h.

294. DOBBS, *supra* note 285, § 4.9, at 298; *see also* Levmore, *supra* note 286, at 65.

295. *See* DOBBS, *supra* note 285, § 4.9, at 299.

296. *See id.*

rendered services are encompassed by this principle.²⁹⁷

Second, one who confers a benefit upon another without affording the recipient an opportunity to decline the benefit has no claim for restitution absent some special policy outweighing the recipient's right to free choice.²⁹⁸ Intermeddlers should not be encouraged to invade the affairs of others by rewarding them for their conduct.²⁹⁹

This second principle is closely linked to the hostility to "officiousness" found in the law of restitution. "A person who receives a benefit through conduct officious as to him does not owe restitution to the person so acting."³⁰⁰ A person may be said to act officiously "when he intervenes in the affairs of another without adequate justification, such as that which may be afforded by a request or a mistake."³⁰¹ A person cannot thrust a benefit on another and thereby become the recipient's creditor.³⁰²

Officiousness should not be a concern in at least two instances relevant to liability insurance and the reimbursement of defense costs. First, action that is requested and that benefits the person making the request is usually not officious insofar as the requesting party is concerned.³⁰³ This principle may apply where an insured asks an insurer to defend a mixed action. Assuming that the insured requests or demands a defense of the action in its entirety, can the insurer's defense of uncovered claims be deemed to be officious? Logically, no. The insured requested the defense and it benefitted from the defense. Second, action taken under duress is deemed not to be officious.³⁰⁴ If an insurer defends under a reservation of rights and the insured threatens to settle or confess judgment, or to make a bad faith claim, the insurer may change its position and defend unconditionally. Is the insurer's defense of an uncovered claim in those circumstances officious? Does the insured's threat of voluntary liability or bad faith constitute "duress" under the law of restitution? The answers to these questions probably depend on the facts of the particular case.

Finally, an expenditure resulting in a mutual advantage will seldom support restitution.³⁰⁵ If the person conferring the benefit or making the expenditure also profits from his action, it does not matter whether he

297. *See id.*

298. *See id.*

299. *See id.*

300. RESTATEMENT, *supra* note 290, at § 2.

301. *Id.*

302. *See id.* § 2 cmt. a.

303. *See id.* § 2 cmt. b.

304. *See id.*

305. *See, e.g.,* *Hettinga v. Sybrandy*, 886 P.2d 772, 776 (Idaho 1994).

did so voluntarily or officiously. If he acted as a volunteer or as an officious intermeddler, the recipient was not unjustly enriched by the benefit conferred.³⁰⁶ If he did not act voluntarily or officiously, there still is no right to restitution because he has suffered no loss.³⁰⁷ After all, he too derived a benefit from his action.

2. *Restitution and Reimbursing Defense Costs*

The court in *Buss v. Superior Court*³⁰⁸ premised Transamerica's recovery of its defense costs attributable to clearly uncovered claims on the law of restitution.³⁰⁹ The *Buss* court reasoned that the insured was enriched by the insurer's "bearing of unbargained-for defense costs" and, because the insurer's financial burden was inconsistent with its freedom under the policy, the insured's enrichment was unjust.³¹⁰ The court did not consider Transamerica's motive in defending the claims that its policy did not cover, observing that an insurer's motive is hard to discern, if not impossible.³¹¹ Accordingly, the court looked only at the results of Transamerica's action.³¹² This is an objective analysis, not a subjective one.³¹³

The insurance industry has warmly embraced *Buss*, hailing the decision as a "major victory."³¹⁴ That it may be, and probably is. The larger issue, however, is whether *Buss* was rightly decided, such that it should become the law nationally. More specifically, when are liability insurers entitled to restitution for defense costs attributable to clearly uncovered claims?

It must first be noted that an insurer seeking the recovery of defense costs can assert a right to restitution only in connection with the defense of a mixed action. This basic principle flows primarily from insurance law, not from the law of restitution. An insurer cannot recover its defense costs in a case in which *all* of the plaintiff's claims are ultimately determined to be outside coverage, for the duty to defend can

306. See RESTATEMENT, *supra* note 290, at § 2 cmt. d.

307. See *id.*

308. 939 P.2d 766 (Cal. 1997).

309. See *id.* at 768-69.

310. *Id.* at 777.

311. See *id.* at 777 n.14.

312. See *id.*

313. See *id.*

314. Brady, *supra* note 6, at 30.

only be extinguished prospectively.³¹⁵ Once it is established that there is no potential coverage under any theory, the insurer's duty to defend ends. The insurer cannot recover its defense costs incurred prior to the determination of no coverage, for until that determination was made the claims were potentially covered and the insurer was obligated to defend them at its expense.³¹⁶ Once it is determined that it has no further duty to defend, the insurer may withdraw its defense, thus eliminating the possibility that it might incur costs defending clearly uncovered claims.

Insurers' right to reimbursement is further limited to the defense of mixed actions by the law of restitution and common sense. An insurer that defends an action in which all of the plaintiff's claims clearly are uncovered surely does so as a volunteer, such that no right to restitution will lie.³¹⁷ As a practical matter, insurers do not defend cases where there clearly is no potential coverage.

An insured undoubtedly benefits by an insurer's defense of an action. This benefit exists even if the defense is provided under reservation. Should an insurer defending under reservation later seek to recoup its defense costs attributable to clearly uncovered claims, the insured still has benefitted from the qualified defense because it did not have to pay for the defense up front. The insurer has essentially made an interest free loan to the insured. The insured had a defense by competent counsel while retaining the use of its money. If the insured is required to make restitution to the insurer, i.e., to repay the insurer for its defense of clearly uncovered claims, the insured is no worse off than if the insurer had never provided a defense.

The benefit to the insured exists without regard for whether the insurer is controlling the defense (as is usually the case) or whether the insured is controlling the defense (as is the case where the insurer pays the insured's independent counsel because of a conflict of interest). In the latter instance the insured cannot possibly claim that it is prejudiced by having to reimburse the insurer because the insured selected its own counsel, just as it would have in any case where it is uninsured, and by directing the defense it was able to control its ultimate liability to the insurer. Again, the insured has received the equivalent of an interest-free loan. If the insurer controls the defense, the most the insured reasonably can argue is that the insurer overspent. Though such a contention seems unlikely,³¹⁸ the insured is free to challenge the defense

315. See *Buss*, 939 P.2d at 773.

316. See *id.* at 775.

317. See *supra* notes 294-97 and accompanying text.

318. There are at least two reasons for thinking it unlikely that an insured might claim that an insurer overspent on a defense. First, this is the exact opposite of what insureds usually purport to fear. Insureds typically contend that insurers do not spend

costs for which reimbursement is sought.

The next question to be asked in analyzing insurers' right to restitution is whether an insurer's defense of claims that are not even potentially covered under its policy constitute an "infringement" of its interests or a "loss?"³¹⁹ These are alternative elements. Clearly, an insurer's payment of defense costs attributable to uncovered claims is a loss to the insurer because it represents a diversion of income.³²⁰ The insurer suffers a loss even if it defends the insured with "staff counsel," i.e., salaried insurance company employees,³²¹ for such a defense represents a wasteful application of the insurer's services.³²² Whether a defense of uncovered claims infringes an insurer's interests is far less clear. An infringement typically is seen as an offense,³²³ and an insured who merely tenders his defense to an insurer or who accepts a defense under reservation has not acted offensively. Of course, there being a loss to the insurer, a determination of infringement is unnecessary.

Finally, an insured who receives a defense for clearly uncovered claims appears to be unjustly enriched. Neither the insured nor the insurer bargained for the insurer to bear the cost of defending uncovered claims.³²⁴ An insurer's defense of clearly uncovered claims is inconsistent with its freedom under the policy and the insured cannot reasonably expect the insurer to defend uncovered claims; as a result, the insured's enrichment by such a defense must be unjust.³²⁵

Looking no further, an insurer that defends clearly uncovered claims would appear to be entitled to restitution from the insured. But the analysis cannot stop there. Generally, for an insurer to have a right to restitution, it cannot have acted as a volunteer, provided the defense officiously, or defended in order to achieve a mutual advantage. If an insurer defends voluntarily or officiously, or if it defends in the pursuit of mutual advantage, the insured's enrichment is not unjust.

enough on the defense of claims for which coverage is questionable. Second, insurers are very sophisticated consumers of legal services. They typically strive to limit defense expenditures to those tasks, items or services that are reasonable and necessary.

319. RESTATEMENT, *supra* note 290, at § 1.

320. *See id.* § 1 cmt. g.

321. For a general discussion of insurers' staff counsel operations, see *Lost in the Eternal Triangle*, *supra* note 70, at 512-14.

322. *See* RESTATEMENT, *supra* note 290, at § 1 cmt. g.

323. *See id.*

324. *See Buss v. Superior Court*, 939 P.2d 766, 776 (Cal. 1997); *A Further Explanation*, *supra* note 247, at 320; *but see Quinn*, *supra* note 75, at 33.

325. *See Buss*, 939 P.2d at 777.

An insurer that defends a mixed action does not do so voluntarily. The insurer must defend a mixed action “as an obligation imposed by law in support of the policy.”³²⁶ Moreover, an insurer that defends a mixed action presumably does so at the insured’s demand or request. The insurer is contractually obligated to defend those claims that are actually or potentially covered, and it cannot reasonably cull out the uncovered claims and defend only the remaining covered claims.³²⁷ The insured’s demand or request for a defense thus *requires* the insurer’s action; the insurer does not defend voluntarily.

Closely linked to the notion of a defending insurer as a volunteer is the concept of an insurer as an officious intermeddler. An insurer should not be able to thrust a benefit upon an insured and later seek payment for it.³²⁸

Any concern that an insurer is acting officiously by defending a mixed action should be eliminated by the insured’s demand or request for a defense.³²⁹ The insured’s demand or request avoids any infringement on his autonomy. An insured’s demand or request for a defense may in fact be an essential element of an insurer’s right to restitution.³³⁰

Additionally, officiousness is not a basis to deny restitution if the party conferring the benefit does so as a result of coercion or duress. The claimed coercion or duress must, of course, result in unjust enrichment to the party acting coercively or causing the duress.³³¹ Unjust enrichment in this situation usually takes one of two forms: either the party acting coercively obtains money or property for which he gives nothing in exchange, or he forces the other party to enter into or perform a contract.³³² This is exactly the situation where an insurer defends an insured as a response to coercion or out of duress: the insured receives a defense for which he paid no premiums, or the insurer performs a contract although it has no obligation to do so.

What, then, is the coercion or duress that might render an insurer’s defense of its insured involuntary? What risks does an insurer face if it wrongfully or erroneously declines to defend its insured? There are minor risks: for example, an insurer that declines to defend may see the insured hire defense counsel who are not as skilled as the attorneys the

326. *Id.* at 775; *see also* *Aerojet-General Corp. v. Transport Indem. Co.*, 948 P.2d 909, 921 (Cal. 1997) (stating that an insurer “has a duty to defend [an] entire ‘mixed’ action imposed by law in support of the policy”) (emphasis in original).

327. *See Buss*, 939 P.2d at 775.

328. *See* RESTATEMENT, *supra* note 290, at § 2 cmt. a.

329. *See id.* § 2 cmt. b (“Action that is requested and that produces a benefit for the person making the request is usually not officious as to him.”).

330. *See id.*

331. *See* GEORGE E. PALMER, 2 THE LAW OF RESTITUTION § 9.4, at 257 (1978).

332. *See id.* § 9.4, at 257-58.

insurer would employ, thereby inflating defense costs and indirectly increasing the insurer's indemnity obligation. There are also very significant risks. An insurer that breaches its duty to defend loses the right to contest the insured's liability, it may lose otherwise valid coverage defenses, it loses the right to control the insured's defense, and it may be bound by the insured's decision to settle or to confess judgment even if the insurer would not have settled on the terms offered.³³³ It therefore seems reasonable to assume that an insurer that defends uncovered claims does so as a result of coercion or duress.³³⁴

That coercion or duress might be assumed does not mean that they cannot be disproved. An insurer that is presented with a case of questionable coverage is not powerless to protect itself. For example, the insurer might defend under a reservation of rights and file a declaratory judgment action.³³⁵ The insurer might intervene in the third-party action, request a bifurcated trial on the issue of coverage, and move to stay litigation of the liability issues until coverage is decided.³³⁶ Alternatively, an insurer might file a declaratory judgment action and ask that the underlying tort action be stayed until the declaratory judgment action is decided.³³⁷ So long as an insurer has a means by which it might reasonably protect its interests, it arguably cannot be coerced into a defense.

An insurer that defends in pursuit of a mutual advantage is not entitled to restitution; the benefit that the insurer receives from the defense means that there can be no loss in need of a remedy. It is here that insurers' right to reimbursement of defense costs is weakest. An insurer that defends under reservation instead of declining to defend may do so to protect itself against a subsequent claim that it breached its duty.³³⁸ If

333. See *supra* notes 54-65 and accompanying text.

334. There may be particular cases in which this assumption is wrong. For example, a case may be so simple or the damages at issue so minor that any settlement of size by the insured can be successfully challenged as being unreasonable. An insurer that defends such an action likely does so for reasons other than coercion or duress.

335. See *Morgan v. Guaranty Nat'l Cos.*, 489 S.E.2d 803, 805 (Ga. 1997) (suggesting this course of action by quoting earlier case); see, e.g., *Guaranty Nat'l Ins. Co. v. George*, 953 S.W.2d 946, 949 (Ky. 1997) (holding that insurer which defended under a reservation of rights and filed declaratory judgment action to determine coverage did not act in bad faith).

336. See *Bradley Corp. v. Zurich Ins. Co.*, 984 F. Supp. 1193, 1198 (E.D. Wis. 1997) (discussing Wisconsin law).

337. See *Ballmer v. Ballmer*, 923 S.W.2d 365, 369-70 (Mo. Ct. App. 1996).

338. See *Travelers Ins. Co. v. Leshner*, 231 Cal. Rptr. 791, 809-10 (Ct. App. 1986), *disapproved by Buss v. Superior Court*, 939 P.2d 766 (Cal. 1997).

so, the insurer defends for its own advantage or benefit; any benefit to the insured is merely incidental.³³⁹

The *Buss* court avoided this obvious impediment to restitution in a footnote.³⁴⁰ The court concluded that “[s]uch reasoning fails” because “[i]t turns on motive.”³⁴¹ Motive lies in the heart and mind, and is therefore difficult to discern.³⁴² This difficulty is magnified in the case of any corporation—the heart or mind of which is purely fictitious. The court thus declined such subjective analysis. The court instead focused on the benefit to the insured that results from the insurers’ defense, which is an objective analysis.³⁴³

If the *Buss* court erred, it did so on this point. Insurers, like all corporations, act through their employees. An insurer’s heart or mind beats or functions in its management personnel. An insurer’s motive can therefore be discerned by way of depositions and company documents. An insurer may defend solely to benefit itself, although the insured also derives a benefit. An insurer might also defend particular claims primarily to benefit the insured. Either way, the insurer’s motive should be discoverable.

The objective analysis employed by the *Buss* court may be the easiest approach, but it is not necessarily the correct one. Policyholders might reasonably argue that basic principles of restitution demand that other courts take the subjective approach that the California Supreme Court rejected. An insurer’s right to restitution will thus turn on the facts of the particular case. This is an unremarkable proposition. Case-specific determinations are common to all areas of the law and insurers’ right to reimbursement should be no different.

Even if an insurer defends to protect itself against the insured’s unilateral action or later claims of bad faith or breach of contract, thus creating a mutual advantage, such self-protection may not bar restitution. The mutual advantage defense to restitution assumes that the party conferring the benefit has time to reflect on the decision.³⁴⁴ That is to be contrasted with the situation in which a person provides assistance in an emergency to a person threatened with a loss. In an emergency, the person conferring the benefit does not gain a material advantage by doing so.³⁴⁵ Restitution in cases of private exigency is granted because of the exigency and without regard for the motive of the party conferring

339. *See id.*

340. *See Buss v. Superior Court*, 939 P.2d 766, 777-78 n.14 (Cal. 1997).

341. *Id.* at 777.

342. *See id.*

343. *See id.* at 777-78.

344. *See* RESTATEMENT, *supra* note 290, at § 2 cmt. d.

345. *See id.*

the benefit.³⁴⁶ The emergency or exigency need not be life-threatening, related to personal safety, or linked to some sort of natural disaster; a purely commercial crisis or business threat suffices.³⁴⁷

An insurer faced with an insured's demand for a defense does not necessarily have time to make a considered decision to defend. The insured is faced with potentially ruinous defense costs and, in many cases, the insured lacks the ability, knowledge or resources necessary to mount an effective defense. Because the discovery of facts necessary to determine the existence or scope of coverage may take months,³⁴⁸ the insured cannot wait for the insurer to study all relevant factors and issues before providing a defense.³⁴⁹ The focus is not the advantage gained by the insurer through its defense, but the potential loss to the insured if a defense is not timely provided. The insurer's advantage should be immaterial.

Absent a private exigency, an insurer might still defeat an insured's claim of mutual advantage. That is because an insurer gains no advantage by defending uncovered claims. An insurer benefits only from defending potentially covered claims, for only its failure to defend those claims (or obviously covered claims) will breach its duty to the insured. There are no negative consequences for an insurer that declines to defend uncovered claims.

If an insurer derives no advantage from defending uncovered claims, there obviously can be no mutual advantage; the only advantage belongs to the insured.³⁵⁰ And, whether described as an advantage or benefit, it is something for which the insured did not pay.³⁵¹ The insured therefore is unjustly enriched and the insurer is entitled to restitution.

3. *Perfecting the Insurer's Right*

An insurer that hopes to recoup its costs incurred defending uncovered

346. *See id.* § 3 cmt. a.

347. *See id.* (extending this principle to the payment of a secured debt).

348. It is also possible that an insured may conceal facts or information from its insurer in an attempt to cloud coverage issues and obtain a defense to which the insured is not rightfully entitled. *See A Further Explanation, supra* note 247, at 320.

349. *See Buss v. Superior Court*, 939 P.2d 766, 775 (Cal. 1997) (observing that “[t]o defend meaningfully, [an] insurer must defend immediately”).

350. As noted previously, an insurer defends uncovered claims in a mixed action not because it has a contractual duty to do so, but because of an obligation imposed by law in support of the policy. *See id.* at 775.

351. *See id.* at 776.

claims must clearly reserve its right to do so. Alternatively, the insured must to agree to reimbursement. As a fundamental matter of insurance law, an insurer must reserve its right to reimbursement, or preserve its right to reimbursement by way of non-waiver agreement or separate contract, in order to avoid a later claim by the insured that it waived its right.³⁵² Under the law of restitution, an insurer must reserve its right in order to establish that it is not a volunteer and that the benefit of a defense was not gratuitously conferred. An insurer's reservation of rights also eliminates any reasonable claim by the insured that he detrimentally relied on the insurer's defense, such that making restitution would leave him worse off than if the insurer had never acted to protect him.³⁵³

In most states, the insured need not consent to the insurer's reservation of rights in order for it to be effective.³⁵⁴ But what if the insured objects to the insurer's reservation? Will the insured's objection defeat the insurer's right to reimbursement?

Applying Texas law, the Fifth Circuit has repeatedly held that an insurer's tender of a defense under reservation, even though rejected by the insured, prevents any breach by the insurer.³⁵⁵ Other jurisdictions have reached the same conclusion.³⁵⁶ This would seem to be the correct position: an insurer should not have to elect between its right to deny coverage for claims outside its policy and its right to protection against the many negative consequences flowing from a breach of the duty to defend. Similarly, an insured should not be allowed to force an insurer to elect between the exercise of its policy right to defend and its right to decline a defense not owed. In short, an insured should not be allowed to extort a benefit to which it is not entitled.

Insurers should carefully select those cases in which they pursue the reimbursement of defense costs. For example, an insurer should not seek reimbursement in a case in which it will appear to be an economic

352. *See id.* at 784 n.27.

353. *See Haz-Mat Response, Inc. v. Certified Waste Servs. Ltd.*, 910 P.2d 839, 847 (Kan. 1996) (suggesting that beneficiary's detrimental reliance might preclude restitution).

354. *See Walbrook Ins. Co. v. Goshgarian & Goshgarian*, 726 F. Supp. 777, 783 (C.D. Cal. 1989) ("[A] survey of the limited number of cases on refusals to consent to reservations of rights . . . shows that the modern trend is to find a unilateral reservation to be effective without the insured's consent.").

355. *See, e.g., United States Aviation Underwriters, Inc. v. Olympia Wings, Inc.*, 896 F.2d 949, 953-55 (5th Cir.), *reh'g denied*, 903 F.2d 826 (1990) (No. 88-2699); *Ideal Mut. Ins. Co. v. Myers*, 789 F.2d 1196, 1200-1201 (5th Cir. 1986); *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 121 (5th Cir. 1983).

356. *See, e.g., American Home Assurance Co. v. Glenn Estess & Assocs., Inc.*, 763 F.2d 1237, 1238-40 (11th Cir. 1985) (interpreting Alabama law; insurer also pursued declaratory judgment action).

bully. An insurer that appears to cross the line from prosecutor of its legal and equitable rights to persecutor of its insured is unlikely to impress a court or jury, and it may well invite a bad faith claim by the insured. Insurers obviously should not pursue insureds who are insolvent or who do not have the means to reimburse the defense costs at issue. There are other good business reasons for insurers to exercise restraint when considering the possibility of restitution. For example, an insurer may have a continuing relationship with an important commercial insured. Commercial insureds often pay six figure annual premiums, and an insurer that sues such a plum insured may lose that business to a competing carrier.

Sophisticated insureds and reasonable insurers who recognize the implications of *Buss* may negotiate their differences at the outset of the underlying tort action, rather than becoming embroiled in expensive coverage litigation to allocate costs later. “Deals [can] be struck for an up-front allocation of all defense costs, with a certain percentage assigned to the insured for payment and a certain percentage assigned to the insurer.”³⁵⁷ Courts seem likely to favor this approach in most cases, for it should reduce litigation.³⁵⁸

V. CONCLUSION

Liability insurers are rightly concerned about defense costs and they have taken a number of steps to reduce them. As a logical extension of their efforts to control defense costs, insurers have long sought to recoup their costs incurred defending uncovered claims from their insureds. Insurers’ right to be reimbursed their defense costs by their insureds has been greatly enhanced by the Supreme Court of California’s recent decision in *Buss v. Superior Court*.³⁵⁹ Whether hailed³⁶⁰ or condemned, *Buss* is a significant decision that reaches well beyond California. Insurers that have overlooked their potential right to reimbursement before are more likely to assert it now, and insureds who have typically taken defenses under reservation for granted must now study the

357. Brady, *supra* note 6, at 31.

358. *See id.*

359. 939 P.2d 766 (Cal. 1997).

360. *See* Brady, *supra* note 6, at 32 (asserting that *Buss* “must be classified as one of the best decision for the insurance industry in California in many years,” and further stating that the decisions restored “equity and balance in the relationship between insurer and insured”).

financial consequences of the bargains they strike with their insurers.

Insurers' right to the reimbursement of their costs incurred defending clearly uncovered claims is well grounded in the law of restitution. Though recognizing insurers' right to reimbursement may strike insureds as unfair, it is no more unfair than requiring an insurer to fund a defense for which it did not bargain. To the contrary, the equities weigh in favor of insurers. An insured who is defended against uncovered claims is unjustly enriched by that defense. The defending insurer is compelled to provide a defense for which it collected no premiums, and should it not defend, the insurer potentially faces significant liability.

That is not to say that an insurer will automatically be entitled to restitution from its insured. Insurers' right to restitution should be determined on a case-by-case basis. Insurers must timely and properly reserve their rights to seek the reimbursement of their defense costs attributable to clearly uncovered claims, and thereafter prove their entitlement to restitution by a preponderance of the evidence. There are sure to be cases in which insurers will not be allowed to recover their defense costs.

Fortunately for insureds, insurers' right to restitution is limited to the defense of clearly uncovered claims in mixed actions. Furthermore, insurers are likely to seek reimbursement only in special cases, characterized by significant defense costs, claims that can be neatly segregated into covered and uncovered categories for allocation purposes, and insureds with the financial resources to bear appropriate defense costs. These factors do not often converge. In the cases where they do, recognizing insurers' right to reimbursement may force insurers and insureds to compromise on the allocation of defense costs, rather than litigating allocation issues in expensive and time consuming coverage actions.