Research Memorandum #82: Duty to Defend

Major Insurance Code (20XX-1):

Section 12743: Conflict of Interest Problems Arising from Insurer's Duty to Defend. "A conflict of interest may arise if the insured is sued for an amount in excess of the insurance coverage and the insurer assumes the defense of its insured. To avoid this, the insurer must act in good faith and immediately disclose any conflict that arises. The insurer can then withdraw or make arrangements for appointment of counsel to alleviate the conflict."

Section 826: Insured's Duty Under Liability Policy. "The insured is required to comply with his obligations under the policy. Breach of the insured's duties such as the duty to cooperate in his or her defense may relieve the insurer of the duty to defend. The breach must be material or prejudicial."

Prejudice Insurance Company v. Hanson, 260 Maj. 3d 518 (20XX-6): "The Prejudice Insurance Company refused to defend its insured, Hanson, in an incident involving Hanson and the Wakefield Shipping Company. The insured, covered by a homeowner's policy, brought an action against the yacht policy insurer for recovery of the settlement sum. Insured was awarded the settlement sum, $500,000; punitive damages of $200,000; attorney's fees; and costs. The insurance company has appealed the judgment.

"An insurer has four alternatives when presented with notice of a claim against its insured.

"1. The insurer can elect to defend. Under a standard insurance policy, the insurer has exclusive control over the defense in any action brought against the insured. The insurer may be precluded from asserting the defense of noncoverage or other policy defenses if it assumes the defense and has not obtained a non-waiver agreement or reserved its rights.

"2. The insurer can elect to defend but reserves its right to bring defenses against the insured. A Reservation of Rights is a unilateral offer by the insurer to defend subject to preservation of the insurer's rights to assert policy defenses.

"3. The insurer can elect to defend, but withdraw from the defense before concluding the case. This is only allowed, however, where prejudice to the insured will not result.

"4. The insurer can seek a declaratory judgment in order to determine if it has a duty to defend.

"The State of Major follows the general rule that an insurer's duty to defend is determined from the allegations of the complaint. The test used is whether the facts alleged in the complaint, if proved, would render the insurer liable under the policy. Major courts liberally construe the pleadings, requiring the insurer to defend if there could be *any* interpretation that creates the duty.

"There are four types of allegations in a complaint:

"1. The allegations clearly fall within or outside the scope of the insurance coverage. The insurer has a duty to defend if the facts alleged are within policy coverage. Conversely, the insurer is not under a duty to defend if the facts alleged are outside the policy.

"2. The factual allegations are both covered and not covered under the policy. Where the court cannot separate the claims within and outside the policy coverage, the insurer is under a duty to defend.

"3. The allegations of the complaint are ambiguous or inadequate. If there is an ambiguity or the allegations are inadequate, the insurer may be required to conduct a reasonable investigation.

"4. There is a conflict between the known or ascertainable facts and the facts as alleged in the complaint. The reasonable investigation rule may apply in this situation.

"Thus, the insurer's duty to defend is not always defined by the facts recited in the complaint. The insurer may be required to go beyond the tactical allegations in the complaint and conduct a reasonable investigation into the facts before disclaiming a duty to defend.

"The insurance company's duty arose even though the complaint failed to describe facts which were covered under the policy coverage. Nevertheless, there was a reasonable possibility that facts would arise in the course of the action which would be covered. And, in fact, these facts did arise. Judgment affirmed."

Gloss Insurance v. Dotts, 276 Maj. 3d 32 (20XX-3): "Gloss Insurance Co. (Gloss) issued Harry Dotts a mobile homeowner's liability policy providing personal liability for damages due to bodily injury caused by an ‘occurrence.' The policy defines 'occurrence' as:

> an *accident*, including injurious exposure to conditions, which results, during the policy term, in bodily injury or property damage.

"The policy excluded from personal liability ‘bodily injury or property damage which is either expected or intended from the standpoint of the insured.'

"During early morning hours, Mr. Dotts went to visit his girlfriend. He found his girlfriend with another man, David McKee. Mr. McKee was sitting on the bed. Dotts and his girlfriend agreed David McKee should leave. Mr. Dotts sat down on the bed next to Mr. McKee and asked him if he would leave. Mr. McKee did not respond nor look at Mr. Dotts. To get Mr. McKee's attention, Mr. Dotts began a motion to slap Mr. McKee with his open palm. Mr. McKee started to lean back, and Mr. Dotts instinctively adjusted the motion of his arm and hand. Thus, the contact between Mr. Dotts' hand and Mr. Mc-Kee's face was an open-handed, backhanded slap. The contact did not mark the insured's hand or McKee's face. No other physical contact occurred. Soon, Mr. McKee left the premises, seemingly unaffected by Mr. Dotts' slap. Later that morning, Mr. McKee was taken to a hospital, where he lapsed into a coma. He died five days later without regaining consciousness.

"A county jury convicted Mr. Dotts of involuntary manslaughter and second-degree assault. At the trial, Mr. Dotts testified he did not intend to hurt the deceased and he was not angry with him; Mr. Dotts just wanted to get Mr. McKee's attention.

"James McKee brought a civil suit for damages. Later, Gloss Insurance filed a separate declaratory judgment action seeking a determination it had no duty to defend Mr. Dotts and no duty to pay any judgment. Gloss moved for summary judgment that David McKee's death was not an ‘occurrence' covered by the policy. Gloss Insurance Company's motion was granted, and James McKee and Mr. Dotts appeal.

"Appellants maintain coverage exists under an ‘occurrence policy’ for intentional acts which cause subjectively unintended resultant injuries. Mr. Dotts' policy equates an ‘occurrence' with an ‘accident.’ The longstanding Major rule

in accidental death in all cases except products liability is:

> [T]o recover under a policy insuring against death or injury by accidental means, (1) it is not enough that the result was unusual, unexpected, or unforeseen, but it must appear that the *means* were accidental; and (2) *accident is never present when a deliberate act is performed, unless some additional unexpected, independent, and unforeseen happening occurs which produces or brings about the result of injury or death.*

"The appellants claim support from *Zinn v. Pride Insurance Co.,* 130 Maj. 2d 921 (20XX-42). In that case, a doctor intentionally made a small incision in the insured's arm to withdraw blood to evaluate treatment of the insured's high blood pressure. The usual precautions for this routine procedure were taken, but the insured nevertheless developed blood poisoning and died from bacteria introduced into the incision. The court found an accident:

> Although the incision which afforded a channel of entry for the germs was intentionally made, the entry of the deadly germs was not normally effected, but was wholly unintentional, unforeseen, and unexpected, and it was the admission of those germs, rather than the intentional act of the doctor, which caused the death. Id. at 923.

In reaching its conclusion, the *Zinn* court articulated the rule which was the majority rule in 20XX-42 as it is today, that 'death is accidental, even though the means are intentional, where the results are unusual, unexpected, or unforeseen.' *Zinn*, at 927.

"But in this case, Dotts intended to slap McKee. His act and the results were foreseeable.

"Having found no material factual issue of whether Mr. McKee's death resulted from the slap, as a matter of law there was no occurrence within the meaning of the insurance policy. We therefore do not address whether the insured's criminal convictions established he subjectively 'expected' or 'intended' to inflict bodily harm on the decedent.

"The judgment of the Superior Court is affirmed."

Reliance Insurance Company v. Randall, 284 Maj. 2d 174 (20XX-1): "The Reliance Insurance Company refused to defend Boe in a negligence action, claiming the action as described in the complaint was not covered by Boe's insurance policy. Plaintiffs obtained a default judgment against Boe for one million ($1,000,000) dollars which was $500,000 in excess of Boe's insurance policy. Boe claimed that the insurance company negligently and in bad faith breached its duty to defend him. Boe claims punitive damages for the company's tortious breach of contract and for his emotional distress because of the company's failure to defend him. Boe assigned his claim against Reliance Insurance Company to plaintiff Randall.

"The trial court ruled that, in determining whether the insurer was guilty of negligence or bad faith in failing to defend the action and to settle for an amount in excess of the policy limits, the jury should consider whether the insurer calculated its potential liability for failure to defend; investigated the potential recoverable damages; concluded what the settlement value of the case would be

after the default judgment; initiated or pursued settlement negotiations after the default judgment; or sought to enlist a contribution from its insured commensurate with that portion of the settlement which the insured should contribute.

"Major courts have adopted the bad-faith test in cases involving an insurer's refusal to settle within the policy limits, and would likewise apply the bad-faith test to excess judgment cases where the insurer wrongfully refused to defend because of a denial of coverage and refused to settle within the policy limits during the course of the litigation.

"The duty of a liability insurer to defend its insured is distinct from, and broader than, the duty to indemnify; the policy gives the insurer the right to defend and to control the investigation, handling, and settling of a lawsuit; and the duty to the insured in the exercise of those rights is in the nature of a fiduciary one, requiring the exercise of good faith. The concept of bad faith presupposes that the company is not attempting to exercise skill, judgment, and fidelity on behalf of the insured.

"Damages for an insurer's emotional distress, caused by his insurer's bad-faith refusal to defend an action against him, have been allowed on a tort theory, *Great Blue Insurance v. Herron*, 268 Maj. 3d 420 (20XX-5). In *Great Blue Insurance*, an automobile liability insurer initially refused to defend a personal injury action against its insured, claiming noncoverage. The insured then sued the insurer in breach of contract and tort before the personal injury action was tried. The insurer undertook the defense of the action against the insured under a reservation of rights. The *Great Blue Insurance* court held that, although the personal injury action against the insured was still pending, the insured was entitled to recover, in tort, for the insurer's breach of the implied covenant of good faith and fair dealing. Damages were allowed for the following injuries: (1) emotional distress resulting from the insurer's initial refusal to defend, and the uncertainty as to whether it would actually defend the personal injury action; and (2) severe emotional distress intentionally inflicted by the insurer. The court stated that to limit the recovery by the insured and the liability of the insurer to the amount of the policy plus attorney's fees and costs in instances in which the insurer has breached its duty to act fairly and in good faith by failing to defend the insured would, in many instances, preclude recovery by the insured for damages for emotional distress.

"Punitive damages for tortious breach of contract and/or emotional distress is recognized by some courts. Major courts, however, have disallowed all but consequential damages for breach of contract. In Randall's case, the insurance company undertook extensive investigation before refusing to defend and in good faith refused to defend. The company is liable only for consequential damages since it acted in good faith."