RESERVATION OF RIGHTS IN INSURANCE CONTRACTS

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INTRODUCTION

Late one Saturday Jerry Langford returned home from an evening of revelry. He fumbled for his keys, unlocked the door, and went inside. As he walked past the study, he noticed an intruder emptying the contents of the wall safe into a sack. A scuffle ensued and a pistol belonging to Jerry somehow discharged, shattering the intruder's left shoulder blade. Rupert, the intruder, subsequently sued Jerry for his injury.

Jerry submitted a claim under his homeowner's insurance policy, which provided coverage for personal liability. Jerry maintained that the pistol discharged accidentally. An adjuster investigated the claim, and concluded that Jerry intentionally shot Rupert and was not acting in self defense. Because Jerry's policy contained an exclusion for intentional acts, the insurer refused to defend Jerry pursuant to the policy terms.

Liability insurance carriers often face claims that may not be covered under the terms of the policy. This type of claim presents the insurer with difficult choices about how the claim should be handled. A judicial declaration of the parties' rights settles any uncertainty, but is not always obtainable prior to a tort action.[1] Therefore, the insurer should reserve the right to contest coverage if it wishes to challenge its obligation to indemnify the claim against the insured. If the company defends the insured without reserving this right, it will be estopped from denying its duty to pay the claim.[2]

A majority of jurisdictions permit an insured to reject an insurer's defense that is subject to a reservation of rights.[3] If the insured refuses the defense, the insurer must either defend the insured unconditionally, waiving all policy and coverage defenses, or deny its duty to defend, in which case it risks a breach of contract action.[4] If the insurer breaches its duty to defend it may be

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1. There are various reasons why prior relief may be denied. *See infra* notes 55-69 and accompanying text.

2. Thornton v. Paul, 74 Ill. 2d. 132, 142, 384 N.E.2d 335, 345 (1978) (citing Note, *Liability Insurance Policy Defenses and the Duty to Defend*, 68 HARV. L. REV. 1436, 1443 (1955)).

3. A. WINDT, INSURANCE CLAIMS AND DISPUTES § 4.24, at 184-85 (2d ed. 1982) (citing Rhodes v. Chicago Ins. Co., 719 F.2d 116 (5th Cir. 1983) (Texas law)); Taylor v. Safeco Ins. Co., 361 So. 2d 743 (Fla. Dist. Ct. App. 1978); State *ex rel* Mid-Century Ins. Co. v. McKelvey, 666 S.W.2d 457 (Mo. Ct. App. 1984).

4. Policy and coverage defenses challenge the duty to indemnify. *See infra* note 58 for an explanation of the distinction between the two.

required to pay for the insured's disposition of the claim even if a valid coverage defense exists.[5]

An emerging minority of jurisdictions have adopted a different approach, whereby the insured is not free to reject the insurer's conditional or conditioned defense. Instead, these courts allow the insured to settle the claim without the insurer's approval.[6] Settlement is permissible in spite of policy terms forbidding it, and the insurer is bound to the settlement provided it is reasonable.[7]

This Note examines the insurer's duties and its relationship with the insured under a standard liability insurance policy. This Note then discusses the two options available to the insurer when litigation involving the insured arises: prior declaratory determination and the reservation of rights. Additionally, the different judicial approaches to the reservation of rights are discussed. This Note suggests that the minority rule affords the insurer a wider range of options than the majority rule, while continuing to provide the insured with substantial protection from personal liability.

AN OVERVIEW OF THE RIGHTS AND DUTIES OF THE LIABILITY INSURER

The insurer owes its policy holder two express duties under a standard liability insurance agreement: the duty to defend and the duty to indemnify.[8] The duty to defend requires the insurer to procure counsel to represent the insured and to pay the expenses of litigating covered claims. The duty to defend is accompanied by the corresponding contractual right of the insurer to control the defense of the claim.[9] This means that the insurer not only directs the litigation, but also decides whether to settle. The insured is also contractually obligated to cooperate with the insurer. The "cooperation clause" is a standard fixture in liability insurance contracts. It protects the insurer's right to a fair adjudication of the insured's liability, prevents collusion between the insured and the claimant,[10] and generally contains an express provision precluding the

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5. *See infra* notes 6-39 and accompanying text.

6. *See, e.g.*, United Services Auto Ass'n v. Morris, 154 Ariz. 113, 121, 741 P.2d 246, 254 (1987); Miller v. Shugart, 316 N.W.2d 729, 733 (Minn. 1982).

7. *See infra* notes 96-123 and accompanying text.

8. Arizona Prop. & Cas. Ins. Guar. Fund v. Helme, 153 Ariz. 129, 137, 735 P.2d 451, 459 (1987).

9. J. APPLEMAN, INSURANCE LAW AND PRACTICE § 4681, at 21 (1979). A typical insurance clause setting forth the responsibilities regarding the defense and the duty to indemnify reads:

> The company will pay on behalf of the insured all sums which the insured shall be legally obligated to pay as damages because of
> A. bodily injury or
> B. property damage
> to which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend the suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false, or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient....

Continental Ins. Co. v. Bayless & Roberts, Inc., 608 P.2d 281, 284 n.1 (Alaska 1980).

10. *Helme*, 153 Ariz. at 137, 735 P.2d at 458 (citing J. APPLEMAN, *supra* note 9, § 4714, at 213).

insured from voluntarily making any payment or assuming any obligation in settlement of the claim.[11]

An insurer's duty to indemnify differs from its duty to defend the insured. The duty to indemnify is simply the insurer's duty to pay the insured for losses realized from risks covered by the policy. It arises when the insured is held legally liable for the claim,[12] provided that the claim is covered and the insured has not breached the policy.[13]

The insurer's duty to defend is broader than its duty to indemnify. Most jurisdictions hold that an insurer must provide a defense when the facts alleged in the complaint bring the claim within policy coverage, regardless of whether the claim in fact has any merit.[14] Thus, though the insurer is bound to defend the insured, it can extinguish any duty to indemnify by successfully defending the insured.[15]

When an insurer does not defend an insured submitting a claim, the insured is also denied the funds needed to settle the claim. This exposes the insured to unmitigated personal liability and forces him to procure a defense at his own cost. Because the refusal to defend constitutes a disclaimer of all obligations under the policy with respect to the claim, the insured is no longer fully bound by the restrictions of the cooperation clause.[16] He may therefore

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11. A. WINDT, *supra* note 3, § 3.01-3.02, at 97. A standard "cooperation clause" reads as follows:

> Insured's Duties in the Event of Occurrence, Claim, or Suit
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> . . . . .
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> (c) The insured shall cooperate with the company and, upon the company's request, assist in making settlements, in the conduct of suits and in enforcing any right of contribution or indemnity against any person or organization who may be liable to the insured because of bodily injury or property damage with respect to which insurance is afforded under the policy; and the insured shall attend hearings and trials and shall assist in securing and giving evidence and obtaining the attendance of witnesses. The insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any expense other than for first aid to others at the time of the accident.

Bayless & Roberts, Inc., 608 P.2d at 291 n.18.

12. Prior to a judicial determination of liability, a defending insurer will often concede its duty to indemnify by settling with the claimant in order to protect itself and its insured from the risk of litigation. A. WINDT, *supra* note 3, § 4.20, at 177.

13. Common policy breaches are non-payment of premiums and failure to cooperate, the latter of which must result in material prejudice to the insurer if it is to be relieved of its obligations. *See* A. WINDT, *supra* note 3, § 3.02, at 97-102; State Farm Mut. Auto. Ins. Co. v. Palmer, 237 F.2d 887, 892 (9th Cir. 1956) (insurer has burden of showing prejudice as a result of the insured's bad faith breach); Baumler v. State Farm Mut. Auto. Ins. Co., 493 F.2d 130, 134 (9th Cir. 1974).

14. *See* Annotation, *Allegations in Third Person's Action Against Insured as Determining Liability Insurer's Duty to Defend*, 50 A.L.R.2d 458, 464 (1956). The minority rule is not as rigid; if the insurer is aware of facts not stated in the complaint that plainly take the claim outside of policy coverage, there is no duty to defend. *See, e.g.*, Kepner v. Western Fire Ins. Co., 109 Ariz. 329, 331, 509 P.2d 222, 224 (1973).

15. The difference in the scope of these duties is graphically illustrated in U.S. Fid. & Guar. Co. v. Louis A. Roeser Co., 585 F.2d 932 (8th Cir. 1978). In that case, the insurer failed to defend its policy holder in a tort suit and, in a subsequent declaratory action, obtained a favorable verdict on the question of coverage. The insured, however, brought an action alleging that the insurer, notwithstanding noncoverage, had breached its duty to indemnify. The court agreed and ordered the insurer to reimburse the insured for the reasonable costs of defending the suit. *Id.* at 940-41.

16. *Helme*, 153 Ariz. at 137-38, 735 P.2d at 459-60.

take whatever steps are necessary to protect himself from personal liability, provided such action does not involve fraud or collusion against the insurer.[17]

One form of protection available to the insured is to enter into a settlement agreement with the claimant whereby the latter agrees by covenant not to execute against the personal assets of the insured.[18] In return for this contractual release from personal liability, the insured assigns all of its claims against the insurer to the claimant[19] and either admits fault by stipulating to a judgment in favor of the claimant or simply agreeing not to plead a defense at trial, permitting the claimant to prove its damages uncontested.[20] Standing in the shoes of the insured, the claimant will then sue the insurer alleging that the insured's policy covers the claim.[21] If coverage is found, the insurer must pay the amount of the judgment unless it can prove that the amount is unreasonable[22] or that the claimant and insured colluded against the insurer.[23] In addition, the insurer may be liable for judgments in excess of policy limits,[24] punitive damages,[25] or damages for mental distress if it acted in bad faith toward the insured.[26] Though these claims belong to the insured, they may be assigned to the claimant under the terms of the settlement.

This type of settlement agreement between the claimant and the insured is valid in an overwhelming majority of jurisdictions,[27] and has received the approval of the Arizona Supreme Court in *Damron v. Sledge*.[28] An insurance company challenged the propriety of these so-called "Damron agreements" in *State Farm Mutual Automobile Insurance Co. v. Paynter*.[29] In *Paynter*, the insured was towing a forklift along a highway at a slow rate of speed and was struck by the claimant's car.[30] The claimant sued and the insurer refused to defend. The insurer asserted that a policy provision excluded insurer liability

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17. *Id.*
18. J. APPLEMAN, *supra* note 9, § 4690, at 229-31.
19. *See, e.g.*, Metcalf v. Hartford Acc. & Indemn. Co., 176 Neb. 468, 475-76, 126 N.W.2d 471, 475-76 (1964). Some courts have held that an assignment of rights pursuant to a covenant not to execute is not an assignment at all. J. APPLEMAN, *supra* note 9, § 4690, at 231 n.9. Because the insurer agreed to indemnify only losses for which the the insured is legally liable, the release of the insured from liability also releases the insurer. *See, e.g.*, Stubblefield v. St. Paul Fire & Marine Ins. Co., 267 Or. 397, 399, 517 P.2d 262, 264 (1973). Arizona follows the majority rule recognizing the validity of such agreements. In Globe Indem. v. Blomfield, 115 Ariz. 5, 8, 562 P.2d 1372, 1375 (1977), the court reasoned that because the covenant was a contract and not a release, the insured's tort liability remained; the claimant could still execute against the insured, though the latter had an action for breach of contract.
20. *See infra* notes 23-31 and accompanying text.
21. *Id.*
22. *See* J. APPLEMAN, *supra* note 9, § 4690, at 229, where the author explains the requirement of reasonableness:

> This standard must be viewed from the point of view of the insured who finds himself cut loose from the protection of the professional risk bearer and who lays no claim to special skills as a negotiator and who may have little time to decide on the best course of action to protect his own interest.

23. *Id.*
24. *See infra* notes 35-51.
25. *Id.*
26. *Id.*
27. A. WINDT, *supra* note 3, § 3.10, at 123-24.
28. 105 Ariz. 151, 460 P.2d 997 (1969).
29. 122 Ariz. 198, 593 P.2d 948 (Ct. App. 1979).
30. *Id.* at 199, 593 P.2d at 949.

for accidents involving "trailers."[31] The insured subsequently agreed to assign its claims against the insurer to the claimant in exchange for a covenant precluding the claimant from executing judgment on the insured's personal assets. Consequently, the insured admitted liability for the accident in a pretrial statement.[32] At trial, the insured did not raise any defenses and did not attempt to modify or dispute the claimant's statement of facts. Among the material facts not revealed to the trial court were the intoxication and excessive speed of the claimant at the time of the accident and evidence that a person was riding on the back of the forklift, presumably to warn vehicles approaching from the rear.[33]

The Arizona Court of Appeals found that coverage existed because the exclusion the insurer relied upon was ambiguous and therefore inapplicable to the claim.[34] The court further held that even though the trial court did not know of the agreement and entered judgment based upon a misunderstanding of the true facts, the judgment could not be attacked for fraud. The court did not find any evidence suggesting that the parties colluded in bringing the suit or that the insured had any interest other than minimizing his loss.[35] The court stated that while it would have been "better practice" to disclose the existence of the Damron agreement to the trial court, the trial court's scrutiny of damages was fair because the claimant's $143,956 damages award was significantly less than his requested damages of $400,000.[36] The court held the insurer liable for the $50,000 limit of the policy.[37]

Paynter illustrates one of the dangers an insurer confronts when refusing to defend an insured. By relinquishing the control that the insurer has when it does defend, the insurer faces the possibility of being bound to a stipulated settlement[38] or, as in *Paynter*, to a judgment resulting from a proceeding that is essentially non-adversarial. The insurer is exposed to other risks as well. The insured may recover its defense costs if the insurer breached its contractual duty to defend.[39] A more serious risk is that the insurer will breach the duties

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31. *Id.* at 203-04, 593 P.2d at 253-04.
32. *Id.* at 200, 593 P.2d at 950.
33. *Id.* at 200-01, 593 P.2d at 950-51.
34. *Id.* at 203-04, 593 P.2d at 953-54.
35. *Id.* at 202, 593 P.2d at 952.
36. *Id.* at 202-03, 593 P.2d at 952-53.
37. *Id.*
38. *See supra* text accompanying note 16.
39. Simple defense costs are merely the contract measure of damages. More particularly, the insurer will be required to pay for "all damages naturally flowing from the breach." Eskridge v. Educator & Executive Insurers, 677 S.W.2d 887, 889 (Ky. 1981). Damages also include court costs and attorneys' fees for the primary tort claim. Sterlite Corp. v. Continental Cas. Co., 17 Mass. App. 316, 322, 458 N.E.2d 338, 344 (1983).

Absent an express contractual provision or statute, courts are divided on whether attorney's fees in a declaratory action to determine the insurer's obligations are recoverable by a prevailing insured. *See* Annotation, *Insured's Right to Recover Attorney's Fees Incurred in a Declaratory Judgment Action to Determine the Existence of Coverage Under Liability Policy*, 87 A.L.R.3d 429 (1978). The Arizona Court of Appeals held in Nationwide Mut. Ins. Co. v. Granillo, 117 Ariz. 389, 573 P.2d 80 (Ct. App. 1977), that Ariz. Rev. Stat. Ann. § 12-341.01, which allows the award of attorney's fees to the successful party in contested actions arising out of contract, permits the insured *and* the claimant who joined in the action to recover. *Granillo*, 117 Ariz. at 394-95, 573 P.2d at 85-6.

A handful of courts hold that an insurer found to be in breach of the duty to defend is estopped from denying coverage under the policy. *See* Clemmons v. Travellers Ins. Co., 88 Ill.

arising out of the covenant of good faith and fair dealing, which is implied at law in all insurance contracts.[40] Because these duties arise out of tort[41] rather than the contract itself, damages for this breach are not constrained to the limits of liability under the contract.[42]

The covenant of good faith and fair dealing requires that neither party act to impair the benefits of the other which exist in the contractual relationship.[43] One specific duty arising from the covenant that courts impose on the insurer is the duty to settle claims. The duty arises when there is a risk of judgment exceeding the policy limits and the insurer would settle the claim if its own liability were not cut off by the limits of the policy.[44] Stated another way, an insurer breaches its duty to settle a claim by failing to weigh the possibility of harm to the insured when deciding whether to settle the claim.[45] Thus, the insurer breaches its duty to the insured when it places its own interests before those of the insured. If the insurer breaches this duty, it may be liable for any subsequent judgment entered against the insured in excess of policy limits.[46]

Claims for the wrongful refusal to settle generally arise in cases where the insurer undertakes the insured's defense, but may also arise where the insurer refuses to defend. In *Comunale v. Traders & General Insurance Co.*,[47] the insurer refused to defend on the basis of a policy exclusion and consequently rejected settlement offers without considering them at all.[48] Judgment in excess of the policy limits was later entered against the insured. The California Supreme Court held the insurer liable for the full amount of the judgment, stating that an insurer should not escape liability for failing in its duty to settle because it first failed to fulfill its duty to defend.[49] The court reasoned that such liability would clearly attach had the insurer properly assumed

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2d 469, 430 N.E.2d 1104 (1981). The *Clemmons* court reasoned that since the insurer failed to exercise its right to contest coverage using a declaratory judgment or defense under a reservation of rights, it should be precluded, as an equitable measure, from later asserting that right because of the burden it imposed on the insured. *Id.* at 479, 430 N.E.2d at 1109. Most courts reject this view, however, because estoppel provides the insured coverage it did not pay for. A. WINDT, *supra* note 3, § 3.09, at 122.

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

41. *Id.* at 758-59.

42. *Id.*

43. Rawlings v. Apodaca, 151 Ariz. 149, 155, 726 P.2d 565, 571 (1986). Many jurisdictions, including Arizona, impose an affirmative duty to initiate settlement negotiations on the insurer. *See* A. WINDT, *supra* note 3, § 5.02, at 235. In Arizona, the duty arises when there is a substantial probability that trial will result in a judgment in excess of policy limits. Fulton v. Woodford, 26 Ariz. App. 17, 22, 545 P.2d 979, 984 (1976).

44. *Rawlings*, 151 Ariz. at 155-56, 726 P.2d at 571-72.

45. *Id.* The standard of care required of an insurer varies among jurisdictions. Some impose liability on the insurer only when it acts in bad faith, while others adopt a negligence standard. A. WINDT, *supra* note 3, § 5.05, at 244. Arizona law requires that the insured show that the insurer acted in bad faith in failing to settle in order to establish a breach of the duty. *Rawlings*, 151 Ariz. at 157. The *Rawlings* court stated:

> As long as [the insurer] acts honestly, on adequate information and does not place paramount importance on his own interests, it should not be held liable because of a good faith mistake in performance or judgment.

Id.

46. A. WINDT, *supra* note 3, § 5.05, at 244.

47. 50 Cal. 2d 654, 328 P.2d 198 (1958).

48. *Id.* at 658, 328 P.2d at 202.

49. *Id.*

the defense prior to failing to settle.[50] In *Comunale*, the court did not find, however, that the insurer's refusal to defend, in itself, was made in bad faith or was in any way tortious. This is significant because it demonstrates the risk of liability beyond the policy limits an insurer assumes by refusing to defend, even if such refusal is made in good faith.[51]

Some courts have held that failure to defend alone is sufficient to support a finding of bad faith tort liability.[52] In *Smith v. American Family Mutual Insurance Co.*,[53] the insured policeman was involved in an accident with a vehicle while on duty. The insurer contended that an exclusion precluded liability coverage. A passenger injured in the accident sued the insured who then retained counsel on his own. The insured's counsel sued the insurer for breach of contract, and the insurer threatened to sue the insured's attorney for abuse of process. The insurer ultimately agreed to pay for the insured's defense, but refused to pay the full fee that the insured and his attorney had previously agreed on ($50 per hour).

The North Dakota Supreme Court held that denying a tort remedy where the insurer acts in bad faith in failing to defend would encourage insurance companies to exert coercion in whatever manner necessary to further their own financial interests, leaving the insured with no remedy other than those already existing under the contract.[54] The *Smith* court upheld the trial court's award of punitive and consequential damages and recognized the propriety of an emotional distress claim, although it found the facts of the case could not support such a claim.[55]

A Michigan court has even imposed excess liability for the wrongful failure to defend in the absence of bad faith where the insured's financial inability to procure defense counsel was the cause of the excess judgment entered against him.[56] The insurer was held liable because the full amount of the judgment entered against the insured flowed directly from the insurer's wrongful failure to defend.[57]

Because of the substantial risks involved, insurers may be hesitant to refuse to defend insureds against claims when their legal obligation to do so is uncertain. The safest course of action is to obtain a judicial declaration of the insurer's duties under the policy. Acting pursuant to a court's instruction insulates the insurer from bad faith tort liability, and absent an appeal, the declaration removes the uncertainty from the contractual relationship. Under the right

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50. *Id.*

51. *See* State Farm Auto. Ins. Co. v. Civil Service Emp. Ins. Co., 19 Ariz. App. 594, 603, 509 P.2d 725, 734 (1973) (The court explicitly states that a good faith denial of defense has no bearing on the insurer's liability for failure to settle.).

52. *See* Annotation, *Insurer's Tort Liability for Consequential or Punitive Damages for Wrongful Failure Or Refusal to Defend Insured*, 20 A.L.R.4th 23 (1983) (citing Tibbs v. Great American Ins. Co., 755 F.2d 1370 (9th Cir. 1985); *Smith*, 294 N.W.2d 751; Decker v. Amalgamated Mut. Cas. Ins. Co., 35 N.Y.2d 950, 324 N.E.2d 552, 365 N.Y.S.2d 172 (1974); Hodges v. State Farm Mut. Auto. Ins. Co., 448 F. Supp. 1049 (D.S.C. 1980)).

53. 294 N.W.2d 751 (N.D. 1980).

54. *Id.* at 759.

55. *Id.* at 758.

56. Maynard v. Sauseda, 121 Mich. App. 644, 654-56, 329 N.W.2d 774, 779-80 (1983).

57. *Id.*

circumstances, this can be accomplished prior to the trial of the tort suit. This remedy, however, has limitations.

LIMITS OF PRIOR DECLARATORY DETERMINATION

When disputes arise over the extent of coverage or the very enforceability of the policy, one of the parties to the insurance contract will generally seek a declaratory judgment to determine the extent of its rights and duties. Because the duty to defend is often determined by the validity of policy or coverage defenses,[58] the insurer will prefer to resolve these issues before the trial of the tort claim so that it may avoid the costs of defending should it prevail. When and whether declaratory relief will be granted, however, lies within the discretion of the trial court.[59]

Denial of Declaratory Relief

Courts have given various reasons for denying insurers prior declaratory relief. One reason is that the insurer does not have the right to delay the primary suit while its obligations under the contract are adjudicated. In denying prior relief, the court in *Zurich Insurance Co. v. Rombough*[60] stated that such delays add to civil case backlogs, waste judicial time, and cause the public to lose faith in the competence of the judiciary.[61]

There are three types of fact situations that allow insurers to contest their duties to defend or indemnify the insured. In the first, the insurer disputes the validity of the policy itself. In this situation the insurer generally alleges nonpayment of premiums, fraud in the procurement of the policy or breach of some policy provision.[62]

Second, the insurer may dispute coverage under the policy, the determination of which depends on facts that are not material to the primary tort claim.[63] An example of this situation would be whether an automobile driven by an insured in an accident was an automobile covered under the policy. While critical to the question of coverage, this issue has no bearing on the insured's tort liability to the claimant.

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58. Policy defenses attack the very validity of the policy alleging some breach by the insured, such as non-payment of premiums or a prejudicial failure to cooperate. *See supra* notes 11-12 and accompanying text. The presence of policy defenses allows the insurer to avoid performance of all contractual obligations. Coverage defenses attempt to establish that the claim was not within policy coverage or fell within an exclusion, thus excusing the insurer from the obligation to pay, and in most jurisdictions, to defend. *See supra* notes 14-15 and accompanying text.

59. Hartford Ins. Group v. District Court, 625 P.2d 1013, 1016 (Colo. 1981).

60. 384 Mich. 228, 180 N.W.2d 775 (1970).

61. *Id.* at 331, 180 N.W.2d at 778. Other factors that may weigh in a court's determination of whether a prior declaratory judgment is proper are that the action may be premature since the duty to indemnify would never arise if the insured won the tort claim (prior declaration was held premature in Aetna Casualty & Sur. Co. v. P.P.G. Indus., 554 F. Supp. 280 (D. Ariz. 1983)), and that the insured or claimant is denied its choice of forum and may face a shifted burden of proof. These issues are discussed thoroughly in Note, *The Role of Declaratory Relief and Collateral Estoppel in Determining the Insurer's Duty to Defend and Indemnify*, 21 HASTINGS L.J. 191 (1969).

62. *See, e.g., Maynard*, 121 Mich. App. 644, 329 N.W.2d 774.

63. *See, e.g.*, Stufflebeam v. Canadian Indem. Co., 157 Ariz. 6, 754 P.2d 335 (Ct. App. 1988).

The third type of situation involves disputed coverage where the outcome of the coverage question depends on the determination of legal conclusions at trial directly impacting the issue of the insured's liability in the tort suit. For example, the insurer asserts that the insured's conduct giving rise to the claim was intentional and therefore excluded from coverage by a standard provision in liability policies.[64]

Procedurally, it is immaterial whether the conflicts in the first two situations are decided before or after the tort suit, except insofar as the insurer's duty to defend is concerned. Because the issues involved are essentially unrelated, the outcome of one suit has no effect on the other. When the judicial declaration and tort suits involve common issues, however, the effects of collateral estoppel must be considered.[65] The court in *Allstate Insurance Co. v. Harris*[66] expressed the concern that, if the insurer establishes in a prior declaratory action that the insured caused the claimant's injury intentionally, the claimant might invoke the doctrine of collateral estoppel in the tort suit to establish the insured's liability for his injury.[67] The court explained that by attempting to establish a conclusive element of the claimant's case to relieve itself of defense obligations, the insurer in this situation severely undermines the interests of its insured, who purchased the policy in anticipation of receiving the protection and aid of the insurer's resources.[68] Recognizing that the insurer who is denied a prior declaration may be burdened by a defense that it had no duty to assume, the court concluded that such a burden was significantly less onerous than the burden imposed on the insured in the alternate scenario.[69]

Where the declaratory action follows the tort suit, most courts suspend the operation of collateral estoppel on issues in which the interests of the insurer and insured are in conflict.[70] In *Farmers Insurance Co. of Arizona v. Vagnozzi*,[71] the insured injured the claimant while the two were playing basketball. The claimant filed suit for negligence and the insurer filed a declaratory action alleging that the claim arose from an excluded intentional act.[72] The claimant obtained summary judgment on the negligence question before the insurer's declaratory action was heard and sought to collaterally estop the insurer from relitigating the issue.[73]

The court explained that because the attorney provided by the insurer in the tort action is bound to faithfully represent the interests of the insured,[74] the insurer should not be estopped from relitigating issues adverse as to its own interests. The court stated that such estoppel would deny the insurer a full and

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64. *See, e.g.*, Farmers Ins. Co. of Arizona v. Vagnozzi, 138 Ariz. 443, 444, 675 P.2d 703, 704 (1983).

65. Collateral estoppel, or issue preclusion, may be asserted regarding an issue in a subsequent litigation that is identical to an issue previously decided on the merits in a prior suit. For collateral estoppel to apply, the party against whom the doctrine is being asserted must have had a full and fair opportunity to litigate the issue in the prior suit. *Hartford*, 625 P.2d at 1016.

66. 445 F. Supp. 847 (N.D. Cal. 1978).

67. *Id.* at 851-52.

68. *Id.*

69. *Id.* at 852.

70. *See* Note, *The Suspension of Collateral Estoppel Between Indemnitors and Indemnitees in the Conflict of Interest Situation*, 27 ARIZ. L. REV. 243 (1985).

71. 138 Ariz. 443, 675 P.2d 703 (1983).

72. *Id.* at 445, 675 P.2d at 705.

73. *Id.* at 447, 675 P.2d at 707.

fair opportunity to litigate those issues on its own behalf.[75] The court noted, however, that in order for the insurer to relitigate these issues it must reserve its right to contest coverage prior to the assumption of the defense.[76]

THE RESERVATION OF RIGHTS

If a prior declaratory determination of the insurer's duties is unavailable, the insurer has three options. It may defend unconditionally, thus waiving policy and coverage defenses. Alternatively, it may refuse to defend. Finally, the insurer may offer the insured a defense while reserving the right to contest its duty to indemnify.[77]

When an insurer assumes the defense, policy terms give it control over the litigation.[78] This may be of paramount importance if the claimant's case is strong and the defenses to the indemnification duty are questionable, because in such a case the insurer can best protect its own interests by assuring that the defense of the insured is conducted properly. Unless the insurer reserves the right to contest its duty to indemnify before accepting the defense, however, it will be estopped from doing so later.[79]

An insurer may preserve this option by sending the insured a reservation of rights letter stating that it intends to reserve the right to contest the duty to indemnify. The insurer may also procure the insured's express consent to such a reservation using a nonwaiver agreement.[80] When the insurer's obligation to indemnify is uncertain, conducting the defense under a reservation of rights allows the insurer to litigate its indemnity obligations during or after the tort suit and avoid the risks of refusing to defend. These benefits often outweigh the corresponding risk that no indemnity obligations in fact existed, in which case defense is unnecessary.

Most courts permit the insured to reject a defense subject to a reservation of rights.[81] If the insured refuses the conditioned defense, the insurer must either defend unconditionally or relinquish all control of the defense to the

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74. *Id.* at 448, 675 P.2d at 708.

75. *Id.* Neither *Vagnozzi*'s holding nor the logic of its rationale requires that the operation of collateral estoppel be suspended with regard to the insured in a later declaratory proceeding, since its interests at trial are fully represented and uncompromised by the defending counsel. *See infra* note 78. Thus, findings essential to the tort ruling are binding on the insured in a subsequent declaratory action.

76. *Vagnozzi*, 138 Ariz. at 448, 675 P.2d at 708.

77. The insurer may reserve the right to contest its obligation to pay either by notifying the insured that it intends to do so by means of a reservation of rights letter or by persuading the insured to sign a nonwaiver agreement in which the insured expressly assents to the reservation. J. APPLEMAN, *supra* note 9, § 4686, at 169-71.

78. *See supra* note 9 and accompanying text. If a conflict exists between the interests of the insured and insurer, the insurer will not be able to control the defense of the insured. It may at least ensure that an adequate defense is provided, though, as most contracts empower the insurer to select or approve independent counsel. A. WINDT, *supra* note 3, § 4.18, at 169-74. Defense counsel provided by the insurer in this situation owes complete fidelity to the insured, even though the insurer is paying him. Parsons v. Continental Nat. Am. Group, 113 Ariz. 223, 226-27, 550 P.2d 94, 97-98 (1976).

79. *Vagnozzi*, 138 Ariz. at 448, 675 P.2d at 708.

80. Some jurisdictions require the express consent of a nonwaiver agreement, while others recognize the unilateral reservation of rights letter as sufficient to preserve coverage and policy defenses. J. APPLEMAN, *supra* note 9, § 4686, at 169-71.

81. A. WINDT, *supra* note 3, § 4.24, at 184-85.

putative insured.[82] In *Taylor v. Safeco Insurance Co.*,[83] Taylor, the insured, initially accepted the insurer's offer of a defense subject to a reservation of rights. The insurer, Safeco, contended that coverage did not apply, arguing that the policy holder who owned the car Taylor was driving at the time of the accident never gave Taylor permission to drive the car. Under the terms of the policy Taylor would not be covered if he had not received permission.[84] In a declaratory judgment, the trial court granted summary judgment in favor of Safeco.[85] Safeco subsequently withdrew its defense. The claimant appealed the summary judgment, at which time Safeco retendered its offer of defense conditioned by the reservation. This time Taylor demanded that the defense be unconditional. When the insurer refused, Taylor rejected the defense and entered into a Damron settlement[86] with the claimant in the amount of $730,000.[87] Safeco contended that Taylor violated the cooperation clause[88] and it therefore was no longer obligated under the policy.

The court disagreed with the insurer, however.[89] The court recognized that the insurer had not actually breached its duty to defend by insisting on the reservation. Nevertheless, the court held that Taylor could reject the conditioned defense and bind the insurer to the settlement if coverage were ultimately decided in Taylor's favor.[90]

Though the vast majority of courts adhere to the foregoing rule allowing the insured to reject a conditioned defense, a small number hold that the insured's refusal of a defense subject to a reservation constitutes breach of the contract's cooperation clause by the insured.[91] In *McGough v. Insurance Co. of North America*,[92] the insureds refused the insurer's defense conditioned by the reservation in a wrongful death action and entered into a Damron agreement with the claimant. At the evidentiary hearing, the plaintiffs informed the court of the agreement in which the insureds stipulated to liability and damages in the amount of $1,100,000, and the insurer sought to intervene.[93] The trial court denied the insurer's motion to intervene and entered a judgment for the stipulated amount in favor of the plaintiffs.[94]

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82. J. APPLEMAN, *supra* note 9, § 4686, at 170.
83. 361 So. 2d. 743 (Fla. Dist. Ct. App. 1978).
84. *Id.* at 744.
85. *Id.* at 745.
86. *See supra* notes 18-28 and accompanying text.
87. *Taylor*, 361 So. 2d at 744.
88. *Id.*
89. *Id.* at 745.
90. *Id.* If coverage exists the insurer would be bound to the extent that the settlement was reasonable and made in good faith. *Id.* at 746.
91. *See, e.g.*, Ferguson v. Birmingham Fire Ins. Co., 254 Or. 496, 460 P.2d 342 (1968), McGough v. Ins. Co. of North America, 143 Ariz 26, 691 P.2d 738 (Ct. App. 1984). In both of these cases, coverage defenses involved issues impacting on liability in the tort suit. The court in *Bayless & Roberts, Inc.*, 608 P.2d 281, adhered to the majority rule in deciding the operation to be ascribed to the reservation of rights where the insurer asserted a *policy* defense. The court noted, however, that where coverage defenses involving tort claim issues form the basis of the insured's reservation, compelling the insured to accept a conditional defense might be proper. *Id.* at 290. The court applied the rationale set forth in *McGough*. *See infra* text accompanying note 92.
92. 143 Ariz. 26, 691 P.2d 738 (Ct. App. 1984).
93. *Id.* at 29, 691 P.2d at 741.
94. *Id.*

The court of appeals held that it was error to deny intervention because the insurer had not breached its duty to defend[95] and as an interested party could intervene under the rules of civil procedure.[96] Furthermore, the court said that the insured could not condition the insurer's right to defend on the waiver of coverage defenses. The court explained that the suspension of collateral estoppel in subsequent actions to determine coverage[97] mitigated any conflict of interest between insured and insurer.[98] The court stated that, in any event, the provided counsel owed complete fidelity to the insured.[99] Concluding that an insurer can only protect itself on the question of the insured's liability by taking part in the defense,[100] the court ordered that intervention be granted, allowing the insurer to contest both the insured's liability and damages.[101]

Both *Taylor* and *McGough* dealt with the right of the insured to refuse a defense offered subject to a reservation. Under either the rule allowing the insured to reject such a defense or the rule permitting the insurer to insist on the reservation as a condition of defense, the insured may assent to such a condition.[102] In *United Services Auto Association v. Morris*,[103] the Arizona Supreme Court held that an insured who was defended under a reservation of rights and subsequently entered into a Damron agreement was not in breach of the cooperation clause.[104] That decision significantly changed liability insurance law in Arizona.

In *United Services*, the tort claim involved the shooting of the claimant by the insured policy holder and her brother, who was also insured under her policy.[105] The claimant sued them alleging gross negligence, and the insureds accepted the insurer's offer to defend under a reservation of rights.[106] The basis of the reservation arose from the insurer's contention that the shooting was an intentional act excluded under the terms of the policy.

USAA, the insurer, hired an attorney named Koontz to conduct the defense. Shortly thereafter, Koontz learned that the claimant amended his complaint to include an allegation that the shooting was intentional. Koontz

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95. *Id.* at 34, 691 P.2d at 746. The court cited Manny v. Estate of Anderson, 117 Ariz. 548, 550, 574 P.2d 36, 38 (Ct. App. 1977), which states that an insurer in breach of the duty to defend is not entitled to intervene in the tort action. *McGough*, 143 Ariz. at 31, 691 P.2d at 743.

96. *McGough*, 143 Ariz. at 31, 691 P.2d at 743.

97. *See supra* text accompanying notes 70-75

98. *McGough*, 143 Ariz. at 33, 691 P.2d at 745. *See also Vagnozzi*, 138 Ariz. 443, 675 P.2d 703.

99. *McGough*, 143 Ariz. at 33, 691 P.2d at 745.

100. *Id.*

101. *Id.* at 29-32, 691 P.2d at 741-44.

102. An insured may assent to a conditional defense if it either cannot afford its own counsel or is unsophisticated and is not aware of its alternatives.

103. 154 Ariz. 113, 741 P.2d 246 (1987).

104. *See also Helme*, 153 Ariz. 129, 735 P.2d 451, and *supra* text accompanying note 8.

105. *United Services*, 154 Ariz. at 115, 741 P.2d at 248.

106. Only one insured had signed a non-waiver agreement. This led the lower courts to conclude that the non-signing insured's defense was unconditional, thus rendering the settlement a clear breach of the cooperation clause and relieving the insurer of any duty to pay the settlement. The Arizona Supreme Court found this conclusion to be clearly erroneous as other documentation revealed that it was the understanding of all parties involved that both were being defended under a reservation of rights. *Id.* at 116, 741 P.2d at 248.

realized that this created a conflict of interest because a finding of intent would benefit the insurer while harming the insured, so he notified USAA that he could no longer represent them and suggested that they retain separate counsel for representation in the suit.[107] Koontz later advised USAA's new counsel that the insureds were negotiating a settlement with the claimant.[108] USAA's counsel responded in a letter stating that it considered the probability of winning the suit to be very high and that any settlement would constitute a material breach of the policy. The letter further stated that USAA intended to seek immediate declaratory action to determine coverage.[109]

The day following his receipt of the letter, Koontz advised the insureds to settle the claim. They entered into a Damron agreement stipulating to a $100,000 judgment to be collected solely from USAA.[110] The insurer filed a declaratory action shortly thereafter asserting both the intentional acts exclusion and breach of the cooperation clause as defenses.

In its analysis, the court sought to determine whether insureds being defended under a reservation may enter into a settlement without breaching the cooperation clause and, if so, whether the insurer is bound to that settlement.[111] The court recognized that although USAA's defense was proper, preventing the insureds from settling subjected them to the risks of non-coverage and excess judgment.[112] The court concluded that leaving the insureds fully bound by the cooperation clause when the insurer refuses to accept full responsibility for their liability exposure[113] is unduly burdensome on the insured.[114] The court then discussed the propriety of allowing the insured to reject a reservation defense and forcing the insurer to defend unconditionally or withdraw from the defense.[115] Stating that this rule imposes an inordinate dilemma on the insurer, the court decided that the rule's results were both unpredictable and often unfair because an unconditional defense deprives the insurer of tenable coverage defenses while refusing to defend subjects it to the risk of greater liability than it would otherwise face.[116]

The court chose to adopt a rule allowing the insurer to satisfy its duty to defend by defending under a reservation of rights.[117] The insured is not permitted to reject the defense[118] but may, after notice is given to the insurer,[119] negotiate a Damron type settlement with the claimant. If liable under

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107. *Id.* at 115, 741 P.2d at 248.
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.* at 114, 741 P.2d at 247.
112. *Id.* at 118, 741 P.2d at 251.
113. This had been the effect of the *McGough* ruling. *See supra* notes 92-99 and accompanying text.
114. *United Services*, 154 Ariz. at 118, 741 P.2d at 251.
115. *See supra* notes 81-90 and accompanying text.
116. *United Services*, 154 Ariz. at 118-19, 741 P.2d at 251-52.
117. *Id.* at 119-21, 741 P.2d at 252-55.
118. Although it is not expressly stated in the opinion that the insurer has a right to compel the insured to accept a defense conditioned by reservation, this seems to be clearly implied by the courts renunciation of the majority rule allowing the insured to reject such a defense.
119. *United Services*, 154 Ariz. at 119-20, 741 P.2d at 252-53.

the policy, the insurer will be bound to pay that part of the settlement that the insured (or claimant) can prove is reasonable.[120]

The majority rule allows the insured to force the insurer into a dilemma when the indemnity obligation is uncertain. The insurer can defend unconditionally, or it can refuse to defend. The *United Services* rule gives the insurer facing uncertain indemnity obligations a third option. The value of having the right to defend under a reservation can be measured in terms of its alternatives.

The advantage over defending unconditionally is that a reservation defense under *United Services* preserves coverage defenses. Defending unconditionally, however, enables the insurer to completely control the defense and settlement terms. The insurer forfeits these powers by defending under a reservation. Because the insured has the right to settle of its own accord, its interests now necessarily conflict with those of the insurer, since the insured's most valuable bargaining chip is admitting liability for the claimant's injury. Because of this conflict, the insurer must provide independent counsel to represent the insured in order to satisfy its duty to defend.[121] The insurer thus preserves coverage defenses at the expense of controlling the defense of the tort suit.

Defending under a reservation also affords the insurer the opportunity to establish nonliability under the policy, but results in double attorney's fees. The advantages available under this option are protection from tort liability and a more conservative standard in determining the reasonableness of settlements between the claimant and insured.

The insurer's other alternative is to refuse to defend. If the insurer successfully establishes nonliability under the policy in the declaratory action, then defense costs are saved. If the insurer is found liable, however, then it risks having to pay the judgment or settlement resulting from the tort claim over the policy limits and faces exposure to tort liability arising from its wrongful failure to defend.

The United Services settlement differs from ordinary Damron settlements in that the settlement figure in the latter carries a rebuttable presumption of reasonableness.[122] The proponent of the United Services settlement bears the burden of proving that the amount is reasonable.[123] The standard by which reasonableness is measured appears to differ as well. In a Damron settlement, the insured's personal financial considerations and negotiating skills may be considered in determining whether the settlement was reasonable.[124] The *United Services* court stated, however, that the test as to whether a settlement is reasonable is what a reasonable person in the insured's position would have settled for based on the merits of the claimant's case.[125] To illustrate this new

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120. *Id.* at 120, 741 P.2d at 253.
121. *See Vagnozzi*, 138 Ariz. 443, 675 P.2d 703, and *supra* text accompanying note 74.
122. J. APPLEMAN, *supra* note 9, § 2696, at 231.
123. *United Services*, 154 Ariz. at 120, 741 P.2d at 253..
124. *See supra* note 22.
125. *United Services*, 154 Ariz. at 121, 741 P.2d at 254. One commentator suggests that the court's emphasis of settlement on the merits precludes consideration of such extrinsic factors. Plitt, *Let's Make a Deal: A Requiem for Reservation of Rights Defenses in Arizona*, 23 ARIZ. B.J. 38, 42 (1988).

standard the *United Services* court cited *Trim v. Clark Equipment Co.*[126] in which the reasonableness of a contract indemnitee's settlement was determined by the expected value of the litigated claim.[127]

The *United Services* court further stated that the proponent's burden of proof is met if it establishes that the settlement was reasonable given the circumstances affecting liability, defense and coverage.[128] Because coverage is a factor unrelated to the tort claim, a reasonable settlement value may be something greater than the simple expected value of the tort suit, which is the amount the insurer and claimant would haggle over if negotiating directly. While this does not clearly delineate the standard, the shifted burden of proof should always result in the consequences of a United Services settlement being more palatable to the insurer than those of a Damron settlement. This is a sensible result, since Damron settlements follow the breach of the insurer's duty to defend.

Because defending under a reservation satisfies the duty to defend, tort liability for breach of this duty, most notably for wrongful failure to settle, is avoided.[129] The duty to settle also exists when the insurer assumes the defense unconditionally.[130] It seems unlikely that an insurer defending under a reservation after *United Services* would owe any such obligation, though, since the insured will be advised by independent counsel and has full power to settle the claim on his own.

Comparing the option of defending under a reservation with the alternatives of defending unconditionally and refusing to defend, the insurer will prefer defending under a reservation in certain situations. The most obvious is where judgment in the tort suit will likely exceed policy limits, and the insurer has a strong coverage defense. In the event that the claim is covered, the insurer will want to avoid tort liability for wrongful failure to settle. Preserving the right to contest coverage is equally important, since the insurer will avoid having to pay the claim if it prevails. Defending under a reservation is the only way to achieve both ends.

Should the insurer choose the reservation option and fail to establish noncoverage, it will want to challenge the reasonableness of the insured's settlement. If the amount is stipulated by the settling parties, the proponent of the settlement bears the burden of proving that it is reasonable. If the settling parties agree to allow a court to determine damages, the insurer should exercise its right to intervene in that proceeding. In Arizona, an insurer who refuses to defend may not intervene.[131] Prior to the *United Services* ruling, an insurer defending under a reservation could intervene in such an action to contest both liability and damages.[132] Although *United Services* precludes the insurer from litigating absolute liability, the insurer may intervene to contest damages.

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126. 87 Mich. App. 270, 274 N.W.2d 33 (1978) (cited in *United Services*, 154 Ariz. at 120, 741 P.2d at 253).
127. *Trim*, 87 Mich. App. at 278, 274 N.W.2d at 37.
128. *United Services*, 154 Ariz. at 120, 741 P.2d at 253.
129. *See supra* notes 43-51 and accompanying text.
130. *Id.*
131. *See supra* note 95.
132. *See supra* notes 84-93.

In *Stufflebeam v Canadian Indemnity Co.*,[133] the insurer offered to defend under a reservation and agreed to the insured's choice of independent counsel. The insured settled, agreeing to consent to a default judgment in return for a release from personal liability. The claimant testified as to its damages at the default hearing and the insurer did not intervene.[134] The trial court awarded the claimant damages exceeding policy limits. The insurer subsequently failed to defeat coverage in a declaratory action and the claimant obtained a writ of garnishment against the insurer for the policy limits.[135]

The Arizona Court of Appeals found in *Stufflebeam* that the insured's agreement did not, as the insurer asserted, violate the cooperation clause[136] and declared that the insurer received adequate notice of the hearing.[137] Therefore, the court held that because the insurer failed to assert its procedural prerogatives of intervening in the action or moving to vacate the default judgment, the trial court's determination of damages would be affirmed.[138]

CONCLUSION

When claims arise under policies of liability insurance the obligations of the insurer can be uncertain. Often the pendency of the claimant's tort action requires the insurer to act quickly in deciding whether to provide its insured with a defense. A reservation of rights permits the insurer to assume the defense without obligating itself to pay for any judgment that might result.

When an insurer asserts a reservation of rights, it is vital that the courts construe the cooperation clause to allow the insured some means of protecting himself from exposure to the risk of potentially devastating liability. In fact, protecting the insured is the primary concern of courts endorsing the majority rule. This rule allows the insured to reject an insurer's attempt to reserve rights in its defense and force the insurer to choose between defending unconditionally and assuming the risks attending the refusal to defend.

United Services affords the insured the same degree of protection offered by the majority rule. At the same time, however, *United Services* allows the insurer to maintain a reservation defense, giving the insurer an additional option to those available under the majority rule. The *United Services* rule allows the insurer to avoid the potential tort liability accompanying a refusal to defend, and at the same time preserve coverage and policy defenses that would be lost in an unconditional defense. Although the insurer forfeits control of the claim by choosing this option, the extent of its liability is limited to the reasonable settlement value of the claim. In addition, the standard of reasonableness under *United Services* is more favorable to the insurer than the standard in ordinary Damron settlements.

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133. 157 Ariz. 6, 754 P.2d 335 (Ct. App. 1988).
134. *Id.* at 9, 754 P.2d at 338.
135. *Id.* at 9-10, 754 P.2d at 338-39.
136. *Id.* at 9, 754 P.2d at 338 (citing *United Services*, 154 Ariz. 113, 741 P.2d 246).
137. *Stufflebeam*, 157 Ariz. at 9, 754 P.2d at 338.
138. *Id.* at 9-10, 754 P.2d at 338-39 (citing *McGough*, 143 Ariz. 26, 691 P.2d 738). *See also* Traver v. Farm Bureau Mut. Ins. Co., 418 N.W.2d 727 (Minn. Ct. App. 1988) where the failure to intervene under Minnesota's application of this rule resulted in similar liability for the insurer.

In sum, the rule adopted in *United Services* reduces the uncertainty surrounding claims involving disputed coverage by providing the insurer a wider range of alternatives than the majority rule. Because the insured fares the same under both rules, the *United Services* rule appears to be the most satisfactory solution to the reservation of rights problem yet proposed.