

INSURANCE RECOVERY OF LITIGATION COSTS: A PRIMER FOR POLICYHOLDERS AND THEIR COUNSEL

Marc S. Mayerson

I. INTRODUCTION

For decades, businesses and organizations of all kinds and sizes have purchased insurance policies that provide protection against financial loss arising from claims of liability by third parties. The type of insurance policy that forms the basis of most companies' liability insurance coverage program is the Comprehensive General Liability (CGL) insurance policy.

The insuring agreement of the typical CGL policy provides:

The [insurance] company will pay on behalf of the insured all sums which the insured shall become 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 any 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. . . .¹

1. SUSAN J. MILLER AND PHILIP LEFEBVRE, MILLER'S STANDARD INSURANCE POLICIES ANNOTATED (4th ed. 1995) [hereinafter I MILLER'S STANDARD INSURANCE POLICIES ANNOTATED], at 451-5 (1973 form CGL policy). The CGL policy was first marketed in 1941. The policy form was drafted by joint committees made up of representatives from leading U.S. insurance companies. The CGL form was revised in 1966 and modified again in 1973. In 1986 the Insurance Services Office, the principal drafting organ for the insurance industry, released a substantially revised policy form. At that time the name of the policy was revised as well. As to the 1986 form, the term "CGL" is an abbreviation for Commercial General Liability, with "commercial" replacing "comprehensive" (which was used in earlier policy forms). As used in this article, the term "CGL policy" refers to the standard-form primary-layer general liability policy issued by the overwhelming majority of American insurers to businesses for nearly half a century. As to most issues concerning the duty to defend, there are no significant differences among the various industry-released forms in use over that period.

Marc S. Mayerson is a lawyer in Washington, D.C. He is counsel for one of the policyholders in Montrose Chem. Corp. v. Canadian Universal Ins. Co. and related proceedings. The opinions expressed in this article are those of the author. He would like to thank Lawrence S. Fox and David Linz for their assistance with the article.

This policy language imposes on the insurer (1) a duty to indemnify the insured for covered judgments and settlements and (2) a duty to defend the insured against suits seeking covered amounts.

CGL policies broadly cover third-party liability arising from bodily injury and property damage caused by an "occurrence," which is, generally speaking, an event or a condition that unexpectedly causes injury or damage.² In addition to its CGL bodily injury/property damage policy a company may have Personal Injury Liability (PIL) coverage or Advertising Injury Liability coverage (or both), which provide coverage for certain "offenses" (instead of "occurrences") taking place in the policy period that result in any of the assorted injuries covered, including injuries associated with certain "business torts" that do not result in (or exclusively in) bodily injury or property damage.³ A company also may have contractual liability insurance, which provides coverage for certain types of contract claims.⁴ These other coverages ordinarily use the broad duty-to-defend language found in CGL policies.⁵

Insurance carriers historically have wanted companies to buy "comprehensive" coverage, and many companies have purchased all the coverage the carriers had to sell. Because the carrier's undertaking of a broad duty-to-defend obligation is an important part of its comprehensive, peace-of-mind coverage, most primary-layer liability policies and coverages provide for defense of the insured.

The types of claims that have been found to be covered by the duty to defend under these more or less common liability insurance coverages include:

- Environmental liability claims⁶
- Intellectual property claims⁷

2. The definition of "occurrence" in the 1973 CGL form states: "'occurrence' means an accident, including continuous or repeated conditions, which results in bodily injury or property damage neither expected nor intended from the standpoint of the insured." *Id.* at 451-3.

3. Subject to the policy terms, PIL insurance covers liability arising from (i) false arrest, detention or imprisonment, or malicious prosecution; (ii) the publication or utterance of a libel or slander or of other defamatory or disparaging material; and (iii) wrongful entry or eviction, or other invasion of the right of private occupancy. *Id.* at 419. Advertising coverage typically includes coverage for "injury arising . . . in the course of the named insured's advertising activities, if such injury arises out of libel, slander, defamation, violation of right of privacy, piracy, unfair competition, or infringement of copyright, title or slogan." *Id.* at 452.5.

4. Among other things, contractual liability coverage covers indemnification-type arrangements covering injury or damage to third parties arising after the date of the contract. *Id.* at 452.4.

5. Companies that provide professional services may purchase professional liability coverage under errors and omissions policies, which often include defense coverage. E&O policies are not nearly as uniform as CGL and certain other liability policies. Defense coverage under director's and officer's liability policies warrants separate treatment. *See generally* *Okada v. MGIC Indem. Corp.*, 823 F.2d 276 (9th Cir. 1986); *Little v. MGIC Indem. Corp.*, 649 F. Supp. 1460 (W.D. Pa. 1986).

6. *E.g.*, *Scottish Guar. Ins. Co. v. Dwyer*, 19 F.3d 307 (7th Cir. 1994); *Blackhawk-Central City Sanitation Dist. v. American Guar. & Liab. Ins. Co.*, 856 F. Supp. 584 (D. Colo. 1994); *Montrose Chem. Corp. v. Superior Ct.*, 861 P.2d 1153 (Cal. 1993).

7. *See, e.g.*, *Federal Ins. Co. v. Microsoft Corp.*, No. C92-610 D, 1993 U.S. Dist. LEXIS 5467 (W.D. Wash. Jan. 10, 1993); *J.A. Brundage Plumbing & Roto-Rooter, Inc. v. Massachusetts Bay Ins. Co.*, 818 F. Supp. 553 (W.D.N.Y. 1993); *Merchants v. American Motorists Ins. Co.*, 794 F. Supp. 611 (S.D. Miss. 1992); *John Deere Ins. Co. v. Shamrock Indus.*, 696 F. Supp. 434 (D. Minn. 1988), *aff'd*, 929 F.2d 413 (8th Cir. 1991).

- Antitrust claims under federal law and similar claims under state-law theories⁸
- Employment practices claims⁹
- Products liability, premises liability, and ordinary tort claims

A company's liability insurance policies thus potentially cover a wide variety of the claims that can be, and indeed are, pursued against it by third parties, which is, of course, why companies and organizations purchase such insurance protection in the first place.

II. THE BREADTH OF AN INSURER'S DUTY TO DEFEND

In virtually every state the standard duty-to-defend language is read very broadly, imposing an obligation on the insurer to defend whenever, as the Delaware Supreme Court put it, "the complaint alleges a risk within the coverage of the policy."¹⁰ To establish right to a defense, an insured need show only that the allegations in the suit permit proof of a claim of the "nature and kind" covered by the policy.¹¹ If a suit expressly or implicitly alleges a set of facts under which the carrier's duty of indemnification would arise (i.e., if it is possible that the carrier will have to pay a judgment (or part thereof) that could result from the suit), the carrier is required to provide a defense.¹² The California Supreme Court summarized the principle succinctly in a recent environmental liability coverage case: "To prevail [in establishing the duty to defend], the insured must prove the existence of a *potential for coverage*, while the insurer must establish *the absence of any such potential*."

8. *Tews Funeral Home v. Ohio Casualty Ins.*, 832 F.2d 1037 (7th Cir. 1987); *Ethicon, Inc. v. Aetna Casualty & Sur. Co.*, 737 F. Supp. 1320 (S.D.N.Y. 1990).

9. *E.g.*, *Solo Cup Co. v. Federal Ins. Co.*, 619 F.2d 1178, 1187 (7th Cir.), *cert. denied*, 449 U.S. 1033 (1980); *Chicago Bd. of Options Exch., Inc. v. Harbor Ins. Co.*, 738 F. Supp. 1184, 1187 (N.D. Ill. 1990); *Transport Ins. Co. v. Lee Way Motor Freight*, 487 F. Supp. 1325, 1328 (N.D. Tex. 1980); *Union Camp Corp. v. Continental Casualty Co.*, 452 F. Supp. 565, 567-68 (S.D. Ga. 1978); *University of Ill. v. Continental Casualty Co.*, 599 N.E.2d 1338, 1351 (Ill. App. Ct.), *appeal denied*, 606 N.E.2d 1235 (Ill. 1992); *Ellis v. Transcontinental Ins. Co.*, 619 So. 2d 1130, 1135 (La. Ct. App.), *cert. denied*, 625 So. 2d 1043 (La. 1993); *cf.* *Board of Educ. v. CNA Ins. Co.*, 647 F. Supp. 1495, 1504 n.5 (S.D.N.Y. 1986).

10. *Continental Casualty Co. v. Alexis I. Dupont Sch. Dist.*, 317 A.2d 101, 103 (Del. 1974).

11. *See Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966).

12. *See Montrose Chem. Corp. v. Superior Ct.*, 861 P.2d 1153 (Cal. 1993); *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991); *Commerce & Indus. Ins. Co. v. Bank of Hawaii*, 832 P.2d 733, 735 (Haw. 1992); *Maryland Casualty Co. v. Peppers*, 355 N.E.2d 24, 28 (Ill. 1976); *Liberty Mut. Ins. Co. v. SCA Servs.*, 588 N.E.2d 1346, 1347 (Mass. 1992); *Fitzpatrick v. American Honda Motor Co.*, 575 N.E.2d 90, 90 (N.Y. 1991); *City of Willoughby Hills v. Cincinnati Ins. Co.*, 459 N.E.2d 555, 558 (Ohio 1984). The rule in New Jersey, where many environmental liability coverage actions have been brought, is somewhat different. The nuances of New Jersey duty-to-defend law warrant separate treatment beyond the scope of this article. *See generally* *Salem Group v. Oliver*, 607 A.2d 138, 139 (N.J. 1992); *Voorhees v. Preferred Mut. Ins. Co.*, 607 A.2d 1255, 1259 (N.J. 1992); *Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7 (N.J. 1970); *Rutgers v. Liberty Mut. Ins. Co.*, 649 A.2d 1362 (N.J. Super. Ct. App. Div. 1994), *review granted*, No. M-875, Sept. Term 1994, 39, 668 (N.J. Mar. 22, 1995); *Morton Int'l, Inc. v. General Accident Ins. Co.*, 629 A.2d 895 (N.J. Super. Ct., App. Div. 1991), *aff'd*, 629 A.2d 831 (N.J. 1993), *cert. denied*, 114 S. Ct. 2764 (1994).

In other words, the insured need show only that the underlying claim *may* fall within policy coverage; the insurer must prove it *cannot*.¹³

An insurer's obligation to defend under a policy is expressed in terms of defending the "suit." A primary carrier's obligation to defend the "suit" is not reduced because other insurers also may have an obligation to defend; it is not enough for a carrier to contribute only "its pro rata share" of the costs of defending the "suit" implicating its coverage.¹⁴ Nor is a carrier's obligation to defend reduced because only part of the claim against the insured may be covered; when a suit against the insured alleges multiple causes of action and only one is potentially covered by the policy, the carrier ordinarily must defend the entirety of the action.¹⁵

Once established, the carrier's duty to defend continues throughout the suit, including appeals,¹⁶ until: (1) the case is concluded, (2) the claims remaining in the case can no longer even potentially lead to a judgment covered by the duty to indemnify, or (3) undisputed facts finally established in the case show that it is no longer possible that the duty to indemnify could apply to any resulting judgment.¹⁷

Because of the broad way in which the duty to defend is construed by the courts, liability insurance policies are often said to provide "litigation insurance."¹⁸

13. *Montrose Chem. Corp. v. Superior Ct.*, 861 P.2d at 1161 (Cal. 1993) (emphasis original); see also *Avondale Indus., Inc. v. Travelers Indem. Co.*, 887 F.2d 1200, 1205 (2d Cir. 1989) (insurer "can be excused from its duty to defend only if it can be determined as a matter of law that there is no possible basis in law or fact upon which the insurer might be held to indemnify" the insured), *cert. denied*, 110 S. Ct. 2588 (1990). When there is a dispute of fact concerning the applicability of a policy exclusion, for example, the carrier is obligated to defend. *Id.*

14. See generally *TPLC, Inc. v. United Nat'l Ins. Co.*, 44 F.3d 1484 (10th Cir. 1995); *Continental Casualty Co. v. Rapid-American Corp.*, 609 N.E.2d 506, 513-14 (N.Y. 1993).

15. E.g., *Horace Mann Ins. Co. v. Barbara B.*, 846 P.2d 792, 795-96 (Cal. 1993) (carrier obligated to defend entire suit in absence of "undeniable evidence" to support allocation of defense costs between potentially covered and uncovered claims); *Seaboard Sur. Co. v. Gillette Co.*, 476 N.E.2d 272 (N.Y. 1989); *Ray Indus. v. Liberty Mut. Ins. Co.*, 974 F.2d 754, 770 (6th Cir. 1992).

16. See, e.g., *Cathay Mortuary (Wah Sang) Inc. v. United Pac. Ins. Co.*, 582 F. Supp. 650 (N.D. Cal. 1984); *Jenkins v. Insurance Co. of N. Am.*, 272 Cal. Rptr. 7 (Ct. App. 1990); *Aetna Ins. Co. v. Borrell-Bigby Elec. Co.*, 541 So. 2d 139 (Fla. Dist. Ct. App. 1989).

17. See *Journal Pub. Co. v. General Cas. Co.*, 210 F.2d 202 (9th Cir. 1954); *Lee v. Aetna Cas. & Sur. Co.*, 178 F.2d 750, 752-53 (2d Cir. 1949); *Montrose Chem. Corp. v. Superior Ct.*, 861 P.2d at 1162 (Cal. 1993); *Firco Inc. v. Fireman's Fund Ins. Co.*, 343 P.2d 311 (Cal. Ct. App. 1959). Even when the carrier successfully persuades a coverage court that, based on developments in the underlying liability case against the insured, there is no longer any possibility that its duty to indemnify could arise (and thus the duty to defend should be terminated), the carrier *continues* to have a duty to defend the insured until such time as the judgment in the coverage case becomes final, including during appellate review. See *Fireman's Fund Ins. Co. v. Chasson*, 24 Cal. Rptr. 726 (Ct. App. 1962). Other circumstances also may dictate that the insurer not be permitted to withdraw from the defense. See, e.g., *Allstate Ins. Co. v. Browning*, 598 F. Supp. 421, 424 (D. Or. 1983); *Ohio Casualty Ins. Co. v. Hubbard*, 208 Cal. Rptr. 806 (Ct. App. 1984).

18. In the words of the Maryland Court of Appeals:

The promise to defend the insured, as well as the promise to indemnify, is the consideration received by the insured for payment of the policy premiums. Although the type of policy here considered is most often referred to as liability insurance, it is "litigation insurance" as well, protecting the insured from the expense of defending suits against them.

Brohawn v. Transamerica Ins. Co., 347 A.2d 842, 851 (Md. 1975) (citation omitted).

This litigation insurance is an incredibly valuable asset to policyholders; indeed, the litigation insurance represented by the duty to defend is often *more valuable* in terms of real dollars than the stated monetary indemnity limits of the policy. This is because the carrier under most liability insurance policies pays for the insured's defense in addition to (on top of) the policy limits. There usually is no per suit or annual dollar limit for amounts the carrier pays under the duty to defend. A policy providing \$50,000 per accident coverage, for example, may pay out an unlimited amount of money to defend a case, even if the defense costs dwarf the carrier's maximum possible obligation under its indemnity policy limits.¹⁹

The insurance against litigation expense most companies possess is thus an asset of great worth because (1) the ease of establishing the duty to defend, (2) the breadth of the carrier's obligation once established, and (3) the fact that the defense dollars paid by the carrier are in addition to its policy limits. Under liability insurance policies, the insured broadly transfers to the carrier the risk of a wide range of third-party suits and all attendant costs.

The defense coverage under a policy, however, is not as a practical matter entirely self-executing. For an insurer to be able to assume its insured's defense, the insurer need learn of the suit. Under most liability insurance policies, the insured promises the insurer that it will provide written notice of claims and suits against it.²⁰ When the insured has provided appropriate notice²¹ of a claim or suit potentially implicat-

19. CGL insurance policies provide this defense-in-addition-to-policy-limits coverage expressly. The standard "Supplementary Payments" provision states:

The [insurance] company will pay, in addition to the applicable limit of liability:

(a) all expenses incurred by the company, all costs taxed against the insured in any suit defended by the company. . . .

See I MILLER'S STANDARD INSURANCE POLICIES ANNOTATED at 451.2. It is in part for this reason that a primary carrier may not tender the policy limits to the insured at the outset of or during a suit and then refuse to defend. See, e.g., *Chubb/Pacif Indem. Group v. Insurance Co. of N. Am.*, 233 Cal. Rptr. 539 (Ct. App. 1987); *Conway v. Country Casualty Ins. Co.*, 442 N.E.2d 245 (Ill. 1982); *Aetna Casualty & Sur. Co. v. Sullivan*, 597 N.E.2d 62 (Mass. App. Ct. 1992).

20. The notice provision in the 1973 CGL policy states:

(a) In the event of an occurrence, written notice containing particulars sufficient to identify the insured and also reasonably obtainable information with respect to the time, place, and circumstances thereof, and the names and addresses of the injured and of available witnesses, shall be given by or for the insured to the [insurance] company or any of its authorized agents as soon as practicable.

(b) If claim is made or suit is brought against the insured, the insured shall immediately forward to the company every demand, notice, summons or other process received by him or his representative.

I MILLER'S STANDARD INSURANCE POLICIES ANNOTATED at 451.4.

21. In most jurisdictions an insurer is required to perform when the policyholder has provided "late" notice unless the insurer can demonstrate that it was so prejudiced by the late notice that the untimeliness rises to the level of a material breach of the insurance contract by the policyholder. The Alaska Supreme Court explained:

We hold that time limit on commencement of suit clauses, notice of loss clauses, proof of loss clauses and cooperation clauses should all be reviewed on the basis of whether their application in a particular case advances the purpose for which they were included in the policy. Only by so reviewing these clauses can courts satisfy the consumer's reasonable expectation that coverage will not be defeated on arbitrary procedural grounds. Thus, in order to bar [the policyholder's] claim for failure to comply with the one-year time limit, [the insurer] must establish . . . prejudice.

ing the carrier's duty to indemnify, the carrier should assume or pay for the full defense of the insured.²²

There have been two developments in recent cases of particular interest to commercial policyholders. First, some courts have begun to suggest that insureds, and particularly larger corporate insureds, must formally "tender" the defense to the carrier. By "tender," these courts mean that the insured must expressly demand that the carrier come to its aid. While there is no support in the policy language for such a "magic words" requirement,²³ as a practical matter insureds may want to include an express demand for coverage in their notice letters.

Second, although the carrier's obligation to pay defense costs should commence from the outset of the claim or suit, if not earlier,²⁴ some courts have suggested, again particularly in the context of larger commercial insureds, that a carrier is not obligated to cover legitimate defense costs paid by the insured before the insured gives notice to the carrier. Nothing in the policy sets forth such a forfeiture provision, and it is wholly fictional to read such a penalty into the policy by arguing, as insurance companies sometimes do, that the insured deliberately "waived" its right

Estes v. Alaska Ins. Guar. Ass'n, 774 P.2d 1315, 1318 (Alaska 1989). When the insurer cannot make such a showing, it is obligated to provide coverage. Indeed, some courts have held that a carrier's late notice defense fails as a matter of law if the carrier denied coverage on multiple grounds and thus would not have participated voluntarily in the insured's defense even if notice had been timely. *E.g.*, *Clemmer v. Hartford Ins. Co.*, 587 P.2d 1098, 1108 (Cal. 1978).

22. After an insured provides notice, an insurer should promptly state its coverage position in writing. *E.g.*, *State v. AMRO Realty Corp.*, 936 F.2d 1420, 1431 (2d Cir. 1991); *Griggs v. Bertram*, 88 N.J. 347 (N.J. 1982); *cf. Barrera v. State Farm Mut. Auto. Ins. Co.*, 456 P.2d 674 (Cal. 1969). When an insurer "reserves the right" to deny indemnity coverage, it sometimes does so in a manner that, as a matter of law in most states, bars the insurer from controlling the defense of the insured. Put differently, when an insurer indicates that it may deny coverage on a basis that implicates disputed facts in the case to be defended, the insurer generally cannot assume the defense, but instead must pay defense costs to "independent counsel" of the insured's choice, whom the insured generally controls. *See, e.g.*, *United States Fidelity & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932, 939-40 (8th Cir. 1978); *Emons Indus., Inc. v. Liberty Mut. Ins. Co.*, 749 F. Supp. 1289 (S.D.N.Y. 1990); *McGee v. Superior Ct.*, 221 Cal. Rptr. 421 (Ct. App. 1985); *Illinois Masonic Medical Ctr. v. Turegum Ins. Co.*, 522 N.E.2d 611 (Ill. App. Ct. 1988); *Prashker v. United States Guar. Co.*, 136 N.E.2d 871, 876 (N.Y. 1956). The insured also has the right to select and control independent counsel when the third-party claim or claims may result in damages in excess of the carrier's policy limits. *See, e.g.*, *Emons*, 749 F. Supp. 1289; *Foremost Ins. Co. v. Wilks*, 206 Cal. App. 3d 251, 260 (1988).

Representation of an insured by defense counsel hired and paid by the insurer presents numerous ethical issues. *See generally* A. WINDT, *INSURANCE CLAIMS AND DISPUTES* § 4.19 (1982); Michael A. Berch, *Insurer, Insurer-Retained Counsel, Insured: A Reexamination of the Conflicts of Interest in the Tripartite Relationship*, 54 J. AIR. L. & COM. 690 (1989); Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured, and Defense Counsel: The Eternal Triangle Reformed*, 66 TUL. L. REV. 511 (1991); Randall Riopelle, *When May an Insurer Fire Counsel Hired to Represent the Insured?*, 7 GEO. J. LEGAL ETHICS 247 (1993).

23. *See Samson v. Transamerica Ins. Co.*, 636 P.2d 32, 44 (Cal. 1981) ("Transamerica argues that it . . . did not refuse to defend the lawsuit, since [the insured] never demanded a defense. The same argument was rejected [previously] as 'sheer sophistry.'") (citations omitted).

24. The defense obligation requires the insurer to pay for "defense costs" incurred in anticipation of a claim that is later brought as a suit or is resolved before a suit is actually filed. *See, e.g.*, *Liberty Mut. Ins. Co. v. Continental Casualty Co.*, 771 F.2d 579, 585-86 (1st Cir. 1985); *New York v. Blank*, 745 F. Supp. 841, 852 (N.D.N.Y. 1990) *aff'd*, 27 F.3d 783 (2d Cir. 1994); *Alderman v. Hanover Ins. Group*, 363 A.2d 1102 (Conn. 1975).

to collect these defense costs.²⁵ As the Tenth Circuit recently held, "in the absence of a showing of prejudice [from late notice], the insurer's duty to defend includes the duty to reimburse for reasonable costs of defense incurred prior to notice, as well as for subsequent defense costs."²⁶ Nevertheless, it is important to note that insurance carriers are resisting payment of prenotice defense costs with increasing frequency. This only underscores the practical importance of providing prompt notice in order to recover the maximum amount of defense costs owed by insurers under their contracts of insurance.

III. WHAT COSTS ARE COVERED BY A CARRIER'S CONTRACTUAL OBLIGATION TO PAY DEFENSE COSTS

Liability insurance policies typically do not define "defense cost," and this lack of a definition leads to numerous opportunities for disagreement over which amounts are and are not covered. The only words used in the policy are "duty to defend," "investigation," and "expense" (all of which are to be contrasted with "damages" for which the insured is liable, which are paid under the duty to indemnify).²⁷ In cases involving disputes over amounts covered by a breaching carrier's duty to defend courts typically have construed the policy language as broadly as the words themselves suggest.

Disputes over defense cost "damages" are increasing in coverage litigation involving larger claims, as insurers seek to reduce their own loss by chipping away at the amounts they are required to pay as part of the duty to defend. A carrier has little incentive to be particularly forthcoming in the zero-sum game represented by the policyholder's claim for payment. Even when claims are resolved informally, it bears noting that, just as many insurers now audit the fees they pay the lawyers that represent them in coverage cases, they are equally inclined to audit the fees

25. A recent Hawaii Supreme Court decision, *Great Am. Ins. Co. v. Aetna Casualty & Sur. Co.*, 876 P.2d 1314 (Haw. 1994), has been misread as establishing that an insured as a matter of law waives its claim to defense coverage for amounts incurred before notice is provided to the insurer. The case involved a contribution action between carriers. The insured never provided notice to one of the carriers, but the other carrier, which was defending the action, did so. Expressly limiting its ruling to the facts of the case before it, the Hawaii Supreme Court held that the defense costs incurred before the defending carrier gave notice were not recoverable in equitable contribution. *Great American* is akin to a line of Illinois cases that vests in the insured absolute discretion to choose which of its defense carriers it wishes to provide coverage, even when the insured has prejudiced the selected carrier's ability to seek equitable contribution from other carriers because the insured did not timely notify them of the suit. See *Aetna Casualty & Sur. Co. v. Chicago Ins. Co.*, 994 F.2d 1254, 1259-62 (7th Cir. 1993); *Institute of London Underwriters v. Hartford Fire Ins. Co.*, 599 N.E.2d 1311, 1315-17 (Ill. App. Ct. 1992).

26. *TPLC, Inc. v. United Nat'l Ins. Co.*, 44 F.3d 1484, 1493 (10th Cir. 1995); cf. *Clarke v. Fidelity & Casualty Co.*, 285 N.Y.S.2d 503, 523 (Sup. Ct. 1967).

27. The insuring agreement, which establishes the defense obligation, states: "[T]he company shall have the right and duty to defend any suit." It also provides that the insurer "may make such investigation . . . of any claim or suit as it deems expedient." See I MILLER'S STANDARD INSURANCE POLICIES ANNOTATED at 451.5. The Supplementary Payments provision, which establishes that defense payments are payable by the insurer in addition to policy limits, refers to "all expenses incurred by the company [and] all costs taxed against the insured in any suit defended by the company." *Id.* at 451.2.

and expenses charged by another company's lawyers and experts.²⁸ This section highlights several of the issues concerning the costs payable pursuant to the duty to defend and outlines practical steps the insured can take to buttress its claim for coverage.

A. Coverage of the Costs of Reasonable Efforts to Defend a Case

Several courts have considered what types of defense costs are recoverable as when a carrier breaches its duty to defend.

The amounts the insured actually incurred in the defense of the underlying case generally are to be recoverable contract damages.²⁹ This is in part because the insurer has an obligation to assume the defense from the outset of the case.³⁰ Under ordinary principles of contract law, the amounts incurred are the natural and probable consequences of the carrier's breach.³¹ The policy language referring to the "duty to defend," "expedient," "investigation," and "expense" thus form the basis for the insured's expectation damages.³²

An insurer should be hard pressed to challenge the appropriateness of defense costs incurred while it sat idly by in derogation of its contractual defense duties. In such circumstances the insured could not have been certain at the time it incurred the costs that the carrier would bear them (in whole or in part), and thus the amounts incurred are presumed to be reasonable. Consequently, the carrier bears the burden of proving that the amounts actually expended were so "unreasonable" as to constitute unforeseeable general damages.³³

28. Note that most policies contain a contractual *limitation* on the right of the insurer to audit the insured's records. The "Inspection and Audit" provision of the standard CGL policy states: "The [insurance] company may examine and audit the named insured's books and records at any time during the policy period and extensions thereof and within three years after the final termination of this policy, as far as they relate to the subject matter of this insurance." The contractual limitation, and the attendant risk the insurer has assumed concerning the quality of the insured's records that may exist more than three years after the policy's expiration, lessens the insured's burden of production of evidence establishing its contract damages for coverage claims pursued years after the policy's expiration.

29. See *Oscar W. Larson Co. v. United Capitol Ins. Co.*, 845 F. Supp. 458, 461 (W.D. Mich. 1993); *Oliver B. Cannon & Son, Inc. v. Fidelity & Casualty Co.*, 484 F. Supp. 1375, 1386 (D. Del. 1980); *Clarke v. Fidelity & Casualty Co.*, 285 N.Y.S.2d 503 (Sup. Ct. 1967).

30. Because the carrier has the duty to relieve the insured of the burden and expense of the underlying litigation, prejudgment interest ordinarily begins to accrue when the insured was invoiced for the defense services rendered. *E.g.*, *Liberty Mut. Ins. Co. v. Continental Casualty Co.*, 771 F.2d 579, 583-85 (1st Cir. 1985); *Foxfire, Inc. v. New Hampshire Ins. Co.*, 1994 U.S. Dist. LEXIS 9249 (N.D. Cal. July 1, 1994).

31. *E.g.*, *Estate of Coppersmith v. Blue Cross & Blue Shield*, 576 N.Y.S.2d 126, 127 (App. Div. 1991).

32. In addition to remedies for bad faith, there may be other forms of damages recoverable in an action for breach of the duty to defend. See, *e.g.*, *Riveredge Assocs. v. Metropolitan Life Ins. Co.*, 774 F. Supp. 897 (D.N.J. 1991); *Brown v. State Auto. & Casualty Underwriters*, 293 N.W.2d 822 (Minn. 1980); *State Farm Fire & Casualty Co. v. Sigman*, 508 N.W.2d 323 (N.D. 1993); *cf.* *Royal College Shop Inc. v. Northern Ins. Co.*, 895 F.2d 670, 679 (10th Cir. 1990); *Barker v. Underwriters at Lloyd's, London*, 564 F. Supp. 352, 358 (E.D. Mich. 1983); *Hochman v. American Family Ins. Co.*, 673 P.2d 1200 (Kan. Ct. App. 1984).

33. *E.g.*, *Collins v. Throckmorton*, 425 A.2d 146, 152 (Del. 1980); *Lawrence v. Will Darrah & Assocs.*, 516 N.W.2d 43, 39 (Mich. 1994); *Estate of Coppersmith v. Blue Cross & Blue Shield*, 576 N.Y.S.2d 126, 127 (App. Div. 1991). Note, however, that some courts refer to the recoverability

In disputes over the reasonableness of the insured's defense costs insurers sometimes question the appropriateness of the counsel the insured has selected, arguing, for example, that "big firm" counsel was or is not required. If the type of case or cases reasonably requires such counsel, courts ordinarily defer to the insured's selection of its defense team and find that the associated costs are recoverable.³⁴ Courts ordinarily also defer to counsel's and the insured's determination of the scope of the defense effort required in a case; courts are highly reluctant to second-guess a decision to pursue a line of inquiry that was thought to hold promise in the defense of the action.³⁵ For the same reasons, if the complexity and size of an action reasonably warrant it, the insurer is generally obligated to pay for local and national defense counsel and "generic" defense efforts applicable to a group of claims (such as are commonly undertaken in mass products liability actions).³⁶ Courts are especially deferential when a case presents substantial (and particularly bet-the-company) amounts of potential damages or unusual factual or scientific complexities.³⁷ All these types of costs may be recoverable in the appropriate case as reasonably foreseeable damages flowing from a carrier's breach of its duty to defend.

only of "reasonable defense costs." See, e.g., *Emons Indus., Inc. v. Liberty Mut. Ins. Co.*, 747 F. Supp. 1079 (S.D.N.Y. 1990); see also 7C JOHN ALAN APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4691, at 261 (1979). One court has placed the burden of proof on the party seeking recovery. *Liberty Mut. Ins. Co. v. Continental Casualty Co.*, 771 F.2d 579 (1st Cir. 1985) (interinsurer dispute).

34. Perhaps the clearest decision on this question is *Continental Corp. v. Aetna Casualty & Sur. Co.*, 1987 U.S. Dist. LEXIS 16133 (E.D. Wis. Oct. 30, 1987). In *Continental* Aetna refused to pay the full rates charged by the defense attorneys because they "were higher than the usual and customary rates for insurance defense work in the Milwaukee area." *Id.* at *17. The court dismissed the objection because the underlying litigation was a complex fraud case, including a RICO claim, alleging millions of dollars of liability. See also *Oscar W. Larson Co. v. United Capitol Ins. Co.*, 845 F. Supp. 458 (W.D. Mich. 1993). Some unique questions arise on this issue concerning the application of California law, particularly the so-called Cumis statute and its retroactive application, a subject that warrants separate treatment. See generally *National Union Fire Ins. Co. v. Hilton Hotels Corp.*, No. C-90-2189 MHP, 1991 U.S. Dist. LEXIS 20123 (N.D. Cal. May 6, 1991); CAL. CIV. CODE ANN. § 2860.

35. See, e.g., *Fireman's Fund Ins. Co. v. Ex-Cell-O Corp.*, 790 F. Supp. 1339 (E.D. Mich. 1992).

36. See generally *Jostens, Inc. v. Continental Cas. Co.*, 403 N.W.2d 625, 627 (Minn. 1987). As to the appropriateness of the fees charged by someone whose work would otherwise be a reasonable part of the defense, the courts generally defer to the rates actually charged, but, as part of a determination of the appropriateness of the fee, may inquire into (i) the education and professional experience of the provider; (ii) the skill, time, and labor required; (iii) the amount at issue in the litigation; (iv) the difficulty and complexity of the case; (v) the nature and length of the professional relationship with the client-insured; and (vi) whether the fees charged by the provider were similar to those charged in similar professional relationships with its clients in similar matters. See generally *Oscar W. Larson Co. v. United Capitol Ins. Co.*, 845 F. Supp. 458 (W.D. Mich. 1993); *Continental Corp. v. Aetna Casualty & Sur. Co.*, 1987 U.S. Dist. LEXIS 16133 (E.D. Wis. Oct. 30, 1987); *Aetna Casualty & Sur. Co. v. Pitrolo*, 342 S.E.2d 156 (W. Va. 1986).

37. As one court put it:

There are wide parameters of reasonableness within which lawyers can exercise professional judgment about which tactics, strategies, and efforts are needed to defend a client. If after refusing to provid[e] a defense, an insurance carrier wishes to second guess the judgment of the defense counsel that was retained by the insured, it is the insurer's burden to demonstrate that the service provided was outside the parameters of this wide range of reasonable professional assistance.

Fireman's Fund Ins. Cos. v. Ex-Cell-O Corp., 790 F. Supp. 1339, 1347 (E.D. Mich. 1992).

To aid in establishing the reasonableness of its defense effort, corporate insureds in particular may want to consider simultaneously documenting the rationale for undertaking certain measures or for hiring certain counsel or experts. Insureds also may also wish to document their efforts to negotiate lower fees or discounts with counsel or their efforts to monitor or even audit the fees and expenses charged. Because the insured may need to convince its insurer informally of the reasonableness of its defense efforts and costs or to prove in court its damages for breach of the duty to defend, it can be quite helpful to document the company's decisions and cost-monitoring efforts concerning defense costs as they are incurred.

B. Coverage for In-House Defense Costs

In-house counsel often are among the active litigators working on behalf of a company. When an insured has in-house counsel participate in a case or draws upon its own people or resources in developing evidence for the defense of the case, at least some of the associated costs to the company may be recoverable under liability insurance policies. The question for coverage purposes is what portion of in-house counsel's efforts reflect ordinary business oversight of the matter (which generally is not recoverable) as opposed to defense work that otherwise would be performed by outside consultants or counsels (which is recoverable).

The courts have recognized that "where an insured . . . assigns an already hired employee to defend, it has incurred an expense just as surely as if it had hired outside counsel."³⁸ As the Third Circuit explained in what is perhaps the leading case:

If [the insured's] attorneys had refrained from activity, the workload and consequently the fee of [outside counsel] would have been increased. There is no reason in law or in equity why the insurer should benefit from [the insured's] choice to proceed with some of the work through its own legal department.³⁹

Courts have permitted insureds to recover these types of in-lieu-of expenses even under policies containing a definition of covered "costs" that expressly carves out salaries of the insured's employees.⁴⁰

While in-house costs are recoverable under liability insurance policies, proving to an insurer or to a jury the amounts actually owed can be difficult. To aid in establishing the amount of recoverable in-house defense costs, it is helpful to document that in-house counsel's ordinary responsibilities are being expanded or that resources are being diverted by the litigation and to document the actual time or other measure of effort devoted to defense by in-house personnel. It also may be helpful to solicit bids from outside companies on large undertakings before concluding that the matter should be handled in-house and to document decisions to use

38. *Travelers Ins. Co. v. State Ins. Fund*, 588 N.Y.S.2d 973, 975 (Ct. Cl. 1992).

39. *Pittsburgh Plate Glass Co. v. Fidelity & Casualty Co.*, 281 F.2d 538, 542 (3d Cir. 1960).

40. *See, e.g., V. Van Dyke Trucking, Inc. v. The Seven Provinces Ins., Ltd.*, 406 P.2d 584 (Wash. 1965); *see also Continental Casualty Co. v. Pittsburgh Corning Corp.*, 917 F.2d 297, 299 (7th Cir. 1990).

in-house resources to perform an investigation or a study (such as expert research) when it would be appropriate for an outside firm or person to do the same work.

Even though recoverable in many instances, the expenses associated with in-house defense efforts often are not pursued by insureds. Some companies do not require in-house lawyers to account for their time in the same manner private law firms do, for example. While it may be somewhat burdensome to document defense efforts during the sometimes hectic pace of a matter, it also is sometimes difficult to segregate these costs after the fact. Companies usually weigh the associated burden of documenting the in-house component of defense costs against the dollar amount of any potential recovery. Nevertheless, a policyholder should be cognizant of potential coverage for these amounts, whether it intends to resolve a potential coverage claim informally with its insurer, intends to litigate, or intends to do nothing at all.

C. Coverage of the Costs Associated with Affirmative Claims

Consistent with the zero-sum nature of the "game" of recovering defense costs, carriers sometimes argue that so-called "offense" costs are not covered by the duty to *defend*. Thus, a carrier may argue that the cost of pursuing counterclaims, cross-claims, third-party claims, or independent actions are not covered by its policy. No exclusion creates this gap in the insured's coverage; rather, the carriers peg this argument entirely on the policy's use of the word "defend" in the insuring agreement, which is an "odd place," as the Washington Supreme Court observed, "to look for exclusions of coverage."⁴¹

Though there is little case-law guidance on the question, an insured should be able to recover the costs of affirmative claims that are "part of the same dispute and were advanced to defeat or offset liability."⁴² Such coverage should be provided if the insured's failure to prosecute such a claim against a party would later preclude it under principles of *res judicata* from prosecuting a claim of offset or contribution (thus potentially impairing the insurer's subrogation claims against that party). Similarly, coverage should be afforded if the insured initiates an independent action against other parties in an effort to reduce the amount of its ultimate liability.⁴³ Nevertheless, the courts are not uniform in their treatment of this issue.⁴⁴

This relative lack of judicial guidance raises the question whether it is sensible or appropriate to try to track so-called offense costs at the time such costs are incurred. While defense counsel potentially could segregate fees into different task

41. *Boeing Co. v. Aetna Casualty & Sur. Co.*, 784 P.2d 507, 511 (Wash. 1990).

42. *Safeguard Scientifics, Inc. v. Liberty Mut. Ins. Co.*, 766 F. Supp. 324, 333-34 (E.D. Pa. 1991), *aff'd in part, rev'd in part without opinion*, 961 F.2d 209 (3d Cir. 1992); *Citadel Holding Corp. v. Rovent*, 603 A.2d 818, 824 (Del. 1992).

43. The question whether such costs are recoverable under insurance policies has become increasingly important in the environmental context in light of the United States Supreme Court's decision in *Key Tronic Corp. v. United States*, 114 S. Ct. 1960 (1994).

44. Decisions expressing a less fulsome view of the recoverability of the cost of prosecuting affirmative claims include *Scottsdale Ins. Co. v. Homestead Land Dev. Corp.*, 1992 WL 453356 (N.D. Cal. 1992), and *Silva & Hill Constr. Co. v. Employers Mut. Liab. Ins. Co.*, 97 Cal. Rptr. 498 (Ct. App. 1971).

numbers, it should be the carrier that bears the burden of proof in allocating offense costs.⁴⁵ As a practical matter, however, at the beginning of complex litigation a company may wish to weigh the relative burden of tracking offense costs, the likelihood of their recoverability as a matter of law, the projected cost of pursuing affirmative claims, and the difficulty of proof of allocation by the carrier.

D. Coverage of Costs Incurred in ADR and Other Nontraditional Proceedings

Liability insurance policies provide a duty to defend "suits" against the insured. Insurers sometimes dispute their obligation to pay defense costs incurred in certain nontraditional fora, such as ADR proceedings (mediation and binding and nonbinding arbitrations) or certain government-sponsored informal dispute-resolution mechanisms (such as industry panels). The more recent litigation on the question of what kind of "suits" a carrier is required to defend has taken place in the environmental context (discussed separately below).

In general, the courts have read the policy's coverage of defense against "suits" expansively, requiring a carrier to pay for the insured's defense in arbitrations, informal industry-sponsored dispute-resolution panels, and government administrative proceedings.⁴⁶ Most policies do not define the word "suit," but those that do often provide that the term "includes an arbitration proceeding to which the insured is required to submit or to which the insured has submitted with the company's consent."⁴⁷ A court is unlikely to find that an insured should be denied defense coverage in a matter that a carrier would be required to defend had it been prosecuted in court instead of through ADR. Many of the leading insurance companies in this country have been championing ADR for years, and they should not be permitted to deny their insureds a practice that the carriers themselves preach.

Nevertheless, when a company is considering submitting a claim against it to ADR, it may be helpful to notify the insurers before agreeing to the ADR process. Similarly, to the extent a company has adopted a formal policy of utilizing alternative methods of dispute resolution, it should furnish a copy to its insurers.

45. See generally *Horace Mann Ins. Co. v. Barbara B.*, 846 P.2d 792 (Cal. 1993); *Petr-All Petroleum Corp. v. Fireman's Ins. Co.*, 593 N.Y.S.2d 693 (App. Div. 1993).

46. See, e.g., *Solo Cup Co. v. Federal Ins. Co.*, 619 F.2d 1178 (7th Cir.), cert. denied, 449 U.S. 1033 (1980); *Simon v. Maryland Casualty Co.*, 353 F.2d 608 (5th Cir. 1965); *Aire Frio S.A. v. United States Fidelity & Guar. Co.*, 309 F. Supp. 1388 (D. C.Z. 1970); *School Dist. No. 1 v. Mission Ins. Co.*, 650 P.2d 929 (Or. Ct. App. 1982); *Community Unit Sch. Dist. No. 5 v. Country Mut. Ins. Co.*, 419 N.E.2d 1257 (Ill. App. Ct. 1981); *Madawick Contracting Co. v. Travelers Ins. Co.*, 120 N.E.2d 520 (N.Y. 1954); *Clarke v. Fidelity & Casualty Co.*, 285 N.Y.S.2d 503 (Sup. Ct. 1967). Note, however, that some contractual liability policies require that the insurance company be "entitled to exercise the insured's rights in the choice of arbitrators and in the conduct of such proceedings." See I MILLER'S STANDARD INSURANCE POLICIES ANNOTATED at 452.4.

47. See *id.* at 451.9. The insurer must grant such consent if reasonable to do so. See generally *Traders & Gen. Ins. Co. v. Rucko Oil & Gas Co.*, 129 F.2d 621, 627 (10th Cir. 1942); *Terzian v. California Casualty Indem. Exch.*, 117 Cal. Rptr. 284, 290 (Ct. App. 1974); *McDonald v. Republic Franklin Ins. Co.*, 543 N.E.2d 456 (Ohio 1989). When a carrier has denied coverage, it is not permitted to invoke a consent clause. E.g., *St. Louis Dressed Beef & Provision Co. v. Maryland Casualty Co.*, 201 U.S. 173 (1906).

E. Recovery of Defense Costs for Environmental Claims

The last decade has seen an explosion of litigation concerning insurance coverage for the environmental liabilities of companies and municipalities arising under the federal Superfund law and other federal and state laws. The duty-to-defend questions on which these coverage cases have focused include (1) whether administrative proceedings initiated by the Environmental Protection Agency or its state counterparts constitute "suits" to which the duty to defend applies and (2) what types of costs incurred in pursuing environmental engineering studies and the like constitute "defense costs" as opposed to "damages" covered only under the carrier's duty to indemnify.

1. Coverage for Costs Incurred in EPA and Similar Administrative Proceedings

In each state insurance companies are taking the position in litigation that administrative proceedings conducted pursuant to CERCLA and similar statutes are not "suits" and that, as a result, the insurers have no obligation to defend or to pay the insured's costs in defending them. A defendant in one of these proceedings, however, is likely to believe itself to be involved in a "suit" and thus endeavor to defend itself and to reduce its potential liability. Unsurprisingly, the majority of cases have found that EPA proceedings and similar proceedings do constitute "suits" covered by the duty to defend.⁴⁸

Nevertheless, while the so-called suit issue has lain relatively quiescent for a few years, the Wisconsin Supreme Court recently held that such proceedings need not be defended by insurers.⁴⁹ The state-by-state battles that have been one of the hallmarks of the environmental liability coverage war thus are likely to continue on this issue. Carriers can be expected to maintain this position during informal discussions concerning coverage resolutions with their insureds.

2. Coverage of the Costs of Investigation

When the government initiates remedial activity at a site, a potentially responsible party (PRP) may face both an administrative action focusing on cleanup efforts and a court action seeking recovery of response costs and the establishment of legal liability. Complex sites often are resolved only after years of studies and reports generated by government consultants and by the PRPs.

In such complex environmental cases it is not uncommon to find that the money paid to experts, consultants, and environmental engineers far exceeds the amount spent on legal services. Nevertheless, the efforts of these nonlawyers may be every

48. See, e.g., *Avondale Indus., Inc. v. Travelers Indem. Co.*, 887 F.2d 1200 (2d Cir. 1989); *United States Fidelity & Guar. Co. v. Specialty Coatings Co.*, 535 N.E.2d 1071 (Ill. App. Ct.), *appeal denied*, 127 Ill.2d 643 (Ill. 1989); *American Bumper & Mfg. Co. v. Hartford Fire Ins. Co.*, 523 N.W.2d 841, 845 (Mich. Ct. App. 1994); *C.D. Spangler Constr. Co. v. Industrial Crankshaft & Eng'g Co.*, 388 S.E.2d 557 (1990); see also *supra* note 46.

49. *City of Edgerton v. General Casualty Co.*, 517 N.W.2d 463 (Wis. 1994); *Lapham-Hickey Steel Corp. v. Protection Nat'l Ins. Co.*, No. 77404, 1993 Ill. LEXIS 89 (May 18, 1995).

bit as essential—indeed more essential—in reducing the company's liability as the work of the lawyers. When the costs of the nonlawyers are substantial, carriers may dispute that some or all of those costs are "expenses" covered by their duty to defend and investigate and contend they are instead "damages" payable, if at all, under the duty to indemnify. Sorting out which efforts in an environmental case are defensive in nature may be somewhat more complicated than in the ordinary case, but the applicable principles are the same.

Investigation is the first thing any defense counsel does in formulating the defense strategy and planning for the presentation of evidence to support the insured's case. Under their plain language, CGL policies provide coverage, in addition to policy limits, for amounts incurred pursuing "investigation" that is "expedient," and courts as a matter of course find that costs of investigation are recoverable under CGL policies. As a Michigan appellate court explained, "the duty to defend necessarily includes any investigation necessary and proper in preparing a defense, for absent such investigation the defense of [the suit] . . . will be seriously impaired."⁵⁰

In environmental cases the insured's consultants may perform studies showing that the conditions at a site have not produced injury or are not so serious as to warrant remedial action or the degree of remedial action contemplated by the government. A consultant also may prepare for the insured a study showing that a remedy different from what the government contemplates is less expensive than but as effective as the government's proposed approach. The cost of these types of studies should be payable as a defense cost.⁵¹ For example, if the government accepts a less expensive alternative proffered by the insured, the insured has reduced the government's damages claim against it. This is the same as hiring an economic expert to project that a tort plaintiff's future earnings are substantially less than what he claims, thus reducing the damages claim against the insured; and there is little dispute that such expert costs are payable under the duty to defend.

In the handful of environmental liability coverage cases addressing the issue, the

50. *Cooley v. Mid-Century Ins. Co.*, 218 N.W.2d 103, 105 (Mich. Ct. App. 1974). See generally *Ballard v. Citizen's Casualty Co.*, 196 F.2d 96 (7th Cir. 1952); *Insurance Co. of N. Am. v. American Home Assurance Co.*, 391 F. Supp. 1097 (D. Colo. 1975); *Hertzka & Knowles v. Salter*, 86 Cal. Rptr. 23 (Ct. App. 1970).

51. As explained in one environmental treatise:

While not strictly a defense to liability, a defendant may seek to avoid its exposure to injunctive relief under section 106 by demonstrating that the government's proposed remedy is unnecessary or unjustified to abate the risk presented by a particular site. The variations on this argument include showing that the relief is not "necessary to abate (the) damage or threat" at the site, that the remedy is improper because of inconsistency with the section 121 cleanup standards or the NCP, or that the proposed remedy will be ineffective, unfeasible, or impractical (e.g., due to technical, economic, or logistical reasons).

Christopher P. Davis, *Liability Under CERCLA for Cleanup of Hazardous Waste*, in *THE LAW OF HAZARDOUS WASTE: MANAGEMENT, CLEANUP, LIABILITY, AND LITIGATION* § 14.02[6][k], at 14-254 (S. Cooke ed. 1990); see, e.g., *United States v. Hardage*, 663 F. Supp. 1280 (W.D. Okla. 1987); *Lone Pine Steering Comm. v. EPA*, 600 F. Supp. 1487, 1498-99 (D.N.J.), *aff'd*, 777 F.2d 882 (3d Cir. 1985); *United States v. Vertac Chem. Corp.*, 588 F. Supp. 1294, 1297 (E.D. Ark. 1984).

courts generally have tried to divide the monies expended between the costs of investigation and the costs of developing or implementing the cleanup measure actually adopted.⁵² Some courts have found that, in addition to "damages" the insured pays in the form of the costs of physically constructing and implementing the cleanup measure, studies and efforts aimed at performing actual cleanup work—design engineering costs and the like—are part of the remedy adopted (i.e., they are part of the "damages" for which the insured is liable) and thus payable pursuant to the carrier's duty to indemnify and not as part of the duty to defend. Other courts have held that recoverable defense costs include all costs of "investigation" regardless of the precise purpose for which the investigation or study was undertaken.⁵³ As a practical matter, the determination of whether such costs are payable as defense (i.e., as a supplementary payment) or as indemnity will turn on the facts of the particular defense effort. In any event, a policyholder's claim for defense costs in environmental cases should presumptively include the costs of the consultants and engineers who aided the defense effort.⁵⁴

To document the claim for defense coverage, particularly when a consultant or engineer is pursuing both defense work and actual cleanup work, it may be sensible to require the consultant to account for his or her time in such a manner that distinguishes between (1) the costs of investigation of the alleged sources or extent of alleged contamination and the costs of developing studies to challenge the necessity or cost of government-contemplated remedies (both of which should be payable as defense costs in virtually all cases) and (2) the costs of designing and implementing the actual response measure (which may, as a practical matter, be more difficult to recover). While the insured probably is required to make some *prima facie* showing as to the amounts it claims as recoverable defense costs (versus potentially recoverable indemnity costs), it should be up to the insurer to prove that some portion of the defense costs alleged are actually "damages."

IV. WHEN MUST OR SHOULD AN INSURED BRING SUIT AGAINST ITS INSURERS FOR FAILING TO DEFEND?

A policyholder faced with a carrier's refusal to afford defense coverage in response to its written notice must consider whether to bring suit against the recalcitrant

52. Perhaps the most comprehensive and searching judicial treatment of this question is *Fireman's Fund Ins. Cos. v. Ex-Cell-O Corp.*, 790 F. Supp. 1318 (E.D. Mich. 1992). See also *New York v. Blank*, 745 F. Supp. 841 (N.D.N.Y. 1990); *South Macomb Disposal Facility v. Westchester Fire Ins. Co.*, No. 84-2686-CZ (Ill. Cir. Ct., Macomb County Feb. 17, 1994), reprinted in 8 MEALEY'S LITIG. REP.: INS., Mar. 8, 1994, at D-1; *General Accident Ins. Co. of Am. v. New Jersey Dept. of Env'tl Protection*, 651 A.2d 472 (N.J. Super. Ct. App. Div. 1995).

53. See, e.g., *General Accident Ins. Co. of Am. v. State*, 651 A.2d 472 (N.J. Super. Ct. App. Div. 1995); *Hi-Mill Mfg. Co. v. Aetna Casualty & Sur. Co.*, No. CV-72494-DT (E.D. Mich., Mar. 27, 1995), reprinted in 9 MEALEY'S LITIG. REP.: INS., May 16, 1995.

54. Defense and supplementary payments coverage may apply to government-imposed costs in the context of CERCLA actions. For example, under 42 U.S.C.A. § 9604(b)(1) (West 1993), the EPA is authorized to assess "planning, legal, fiscal, economic, engineering, architectural and other studies

carrier. Generally speaking, for statute-of-limitation purposes the insured need not initiate coverage litigation until the underlying action is concluded; using different rationales, most courts that have addressed the issue have found that the limitation period starts upon termination of the underlying suit.⁵⁵ In the words of the California Supreme Court, "[t]he insured must be allowed the option of waiting until the duty to defend has expired before filing suit to vindicate that duty."⁵⁶

Nevertheless, it can be in the insured's interest to bring a prompt duty-to-defend action. Because the duty to defend is determined with reference to the undisputed facts surrounding a claim—which at the outset of a case usually are limited to the policy language and the broad allegations of the complaint—it may be easier as a practical matter to establish a carrier's duty to defend before substantial fact-finding has occurred in the underlying action. Moreover, when an insured initiates an early coverage action against its insurer, the insured may be able to obtain a judgment that already-incurred defense costs are payable by the insurer and *specific performance* of the duty to defend requiring the insurer to pay all such costs in the future.⁵⁷

There is one potentially serious detriment to pursuing a coverage action while the underlying liability action is pending. In such a duty-to-defend suit the carriers may allege and attempt to prove that there is no coverage because the plaintiffs' bad-actor allegations in the underlying action are *true* and thus an exclusion to coverage should apply to the judgment in the liability case. Such a contention

or investigations to plan and direct response actions." Costs imposed on an insured under this taxation-of-costs statute should be recoverable supplementary payments. *See generally* *Argento v. Village of Melrose Park*, 838 F.2d 1483, 1489 (7th Cir. 1988).

55. *See* *Moffat v. Metropolitan Casualty Ins. Co.*, 238 F. Supp. 165 (M.D. Pa. 1964); *Lambert v. Commonwealth Land Tide Ins. Co.*, 811 P.2d 737 (Cal. 1991); *Kielb v. Couch*, 374 A.2d 79 (N.J. Super. Ct. Law Div. 1977). There is a surprising paucity of case law on the application of statutes of limitations to insurance claims, and it is highly advisable that each claim for which the insured may seek defense coverage be evaluated individually, bearing in mind also that the choice of forum may affect the statute of limitations applied under the so-called "borrowing" statute in most state codes. *E.g.*, DEL. CODE ANN. tit. 10, § 8121 (1975); CAL. CIV. PROC. CODE § 361 (West 1982); N.Y. CIV. PRAC. L. & R. 202 (McKinney Consol. 1990); *see also* *Heavner v. Uniroyal, Inc.*, 305 A.2d 412, 418 (N.J. 1973).

56. *Lambert*, 811 P.2d at 740.

57. *See, e.g.*, *McGinniss v. Employers Reinsurance Corp.*, 648 F. Supp. 1263, 1271 (S.D.N.Y. 1986). The case with the most comprehensive and sweeping discussion of the policyholder's right to obtain specific performance is probably *Montrose Chem. Corp. v. American Motorists Ins. Co.*, 16 Cal. Rptr. 2d 516 (Ct. App. 1993). In this case the California Court of Appeal reasoned:

The insured should not have to wait until it has a fully matured breach of contract action and forgo its right to a defense under the policy. One purpose of purchasing CGL insurance is to obtain peace of mind that the carrier will defend against third party lawsuits which potentially seek damages within the coverage of the policy. None of the policies herein required the insureds to fund their own defense and then seek reimbursement for defense costs when it became certain that the claims would be covered by the policies [duty to indemnify]. The right to seek reimbursement and to sue for breach of contract are inadequate remedies as a matter of law because the duty to defend is much broader than the duty to indemnify.

Id. at 533. Review of the *Montrose* decision was granted and later dismissed by the California Supreme Court. Due to unique California procedural rules, the decision is no longer citable to California courts. *See generally* *Montrose Chem. Corp. v. Superior Ct.*, 31 Cal. Rptr. 2d 38, 40-41 (Ct. App. 1994) (later proceeding).

generally will not defeat the carrier's duty to defend.⁵⁸ Nevertheless, the possible exposure to simultaneous litigation of the "black hat" allegations—by the underlying plaintiff and by its insurers—is a genuine cause for concern. A carrier also may contend it has no indemnity obligation because the underlying plaintiff was injured in a different policy period, but the insured may be contending in the underlying liability action that the plaintiff was not injured at all. The insured thus could face the prospect of needing to prove that injury occurred and when it occurred in order to prevail in the coverage case, thus sacrificing its defense in the underlying liability case that the plaintiff did not sustain an injury.

Recognizing that no policyholder would expect the price of securing performance of the duty to defend from a breaching insurer carrier to be so great, policyholders have argued that the duty-to-indemnify portion of a coverage action must be stayed or dismissed while the underlying action is pending because the duty-to-indemnify issues (1) are premature (the insured may win the underlying suit) or (2) turn on facts that are at issue in the underlying action (and thus litigation about those facts in the coverage case could potentially prejudice the insured in its defense of the underlying action). This question has been litigated in a few environmental liability coverage cases, and the courts are increasingly holding that the duty-to-indemnify portions of coverage cases may be stayed as requested by the insured.

The courts adopting this view have reasoned that "the insurer must not be permitted to join forces with the plaintiffs in the underlying actions as a means to defeat coverage"; that the insured should not be "compelled to fight a two-front war, doing battle with the plaintiffs in the third party litigation while at the same time devoting its money and its human resources to litigating coverage issues with its carriers"; and that the insured should not be exposed to the risk of being collaterally estopped "from relitigating any adverse factual findings [from the coverage action] in the third party action, notwithstanding that any fact found in the insured's favor [in the coverage action] could not be used to its advantage."⁵⁹ In determining whether the indemnity-coverage portion of a case must be stayed, the courts consider whether "the coverage question is logically unrelated to issues of consequence in the underlying action."⁶⁰ If not, proceedings on the duty to indemnify should be stayed.⁶¹

58. See *supra* notes 55-56 and accompanying text.

59. *Montrose Chem. Corp. v. Superior Ct.*, 31 Cal. Rptr. 2d 38, 43 (Ct. App. 1994); see also *New York v. Blank*, 1991 U.S. Dist. LEXIS 14582 (N.D.N.Y. Oct. 9, 1991); *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1086 & n.5 (Colo. 1991); *Prashker v. United States Guar. Co.*, 136 N.E.2d 871, 875 (N.Y. 1956); *Morris v. Farmer's Ins. Exch.*, 771 P.2d 1206, 1212 (Wyo. 1989).

60. *Montrose Chem. Corp. v. Superior Ct.*, 861 P.2d 1153, 1162 (Cal. 1993).

61. In one recent environmental liability coverage case the court, in response to the insureds' request for a stay, painstakingly analyzed each of the carriers' principal coverage defenses. The court found that, "[a]s to each of the coverage defenses outlined in the [insurers'] pleadings, the plaintiffs made a sufficient showing of a significant overlap of issues of consequence and proved that they would be prejudiced unless adjudication of those defenses was stayed." *Montrose Chem. Corp. v. Canadian*

An insured thus may be able to initiate early coverage litigation with its liability insurance carriers and obtain (1) summary judgment on the insurer's duty to defend, (2) payment of past defense costs, (3) specific performance of the duty to defend the suit in the future, and (4) a stay of all further proceedings concerning the carrier's potential duty to indemnify the insured for any judgment or settlement in the suit to be defended, including a stay of expensive factual discovery in the coverage case.⁶² The peace-of-mind coverage provided by the litigation insurance represented by the duty to defend requires no less.

V. CONCLUSION

Policyholders for decades have paid for defense coverage under their liability insurance policies. This "litigation insurance"—insurance against the expense and burden of defending claims—is a very valuable asset of policyholders. Whether an insured pursues all the coverage it purchased should be the result of a conscious business and legal decision, not a "decision" made by default.

62. See, e.g., *Haskel, Inc. v. Superior Ct.*, 39 Cal. Rptr. 2d 520 (Ct. App. 1995).