Liability Insurer's Duty to Defend

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Tony Stewart, the NASCAR Champion, was sued by the Estate of Kevin Ward, who was struck and killed when he walked onto the course during a Sprint Cup race on August 9, 2014. Stewarts' CGL, auto and excess insurers denied a duty to defend Stewart in the lawsuit. As counsel for Tony Stewart, how do you advise your client?

The duty to defend forms the backbone of the insurance defense industry, but what do we know about it? How do we measure the duty? What is the scope of the duty to defend? What are the consequences of failing to defend? When does the duty terminate? What if, after the jury verdict, there was no duty to defend?

An insurer must defend and indemnify its insured if it is sued by a third party because of an act covered by the policy. The duty to defend is a contractual, not common law, duty usually found in the insuring clause. However, the courts' decisions on this simple duty fill volumes.

A. Standard for Measuring the Duty to Defend

An insurer's duty to defend is measured by two tests: (1) the potentiality rule; and (2) the comparison test. The Maryland Court of Appeals first articulated the potentiality rule in *Brohawn v. Transamerica Insurance Company*:

> The obligation of an insurer to defend its insured under a contract provision… is determined by the allegations in the tort actions. If the plaintiffs in the tort suits allege a claim covered by the policy, the insurer has a duty to defend. Even if a tort plaintiff does not allege facts which clearly bring the claim within or without the policy coverage, the insurer still must defend if there is a *potentiality* that the claim could be covered by the policy.[1]

The Court further explained how to determine whether there is a potentiality of coverage in *St. Paul Fire & Marine Insurance Co. v. Pryseski*, where the Court adopted the comparison test, also known as the "four corners rule" or the "exclusive pleading rule":

> In determining whether a liability insurer has a duty to provide its insured with a defense in a tort suit, two types of questions ordinarily must be answered:
> (1) what is the coverage and what are

[1] 276 Md. 396, 407-08, 347 A.2d 842, 850 (1975) (internal citations omitted) (emphasis added).

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> the defenses under the terms and requirements of the insurance policy? (2) do the allegations in the tort action potentially bring the tort claim within the policy's coverage? The first question focuses upon the language and requirements of the policy, and the second question focuses upon the allegations of the tort suit.[2]

The comparison test compares the allegations of the complaint with the policy coverage. The court must accept the allegations as true no matter how "attenuated, frivolous, or illogical that allegation may be."[3]

B. The Exclusive Pleading Rule Unchained

The comparison test normally restricts the evidence used to determine the duty to defend to the complaint and the policy language. However, an insured may rely on extrinsic evidence outside of the complaint to establish a duty to defend where the complaint "neither conclusively establishes nor negates a potentiality of coverage."[4]

> The extrinsic evidence must relate in some manner to a cause of action actually alleged in the complaint and cannot be used by the insured to create a new, unasserted claim that would create a duty to defend. Unasserted causes of action that could potentially have been supported by the factual allegations or the extrinsic evidence cannot form the basis of a duty to defend because they do not demonstrate a reasonable potential that the issue triggering coverage will be generated at trial.[5]

Any uncertainty as to whether there is a duty to defend is resolved in favor of the insured.[6] Moreover, an ambiguous allegation may also trigger a duty to defend; for example, where the allegations in the complaint do not specifically allege that the loss occurred during the policy period, there is a duty to defend.[7]

Insurers, on the other hand, may not rely upon extrinsic evidence to deny coverage.[8] This includes whether the putative insured qualifies as an insured.[9] There is an exception to this rule permitting an insurer to contest coverage with extrinsic evidence where there is uncontroverted evidence that clearly establishes that there is no potentiality for coverage.[10] A court need not "turn a blind eye where, as here, it is firmly established by judicial decree that an insured tortfeasor is excluded from coverage under particular terms of the insurance policy."[11]

C. Ambiguous Policies + Extrinsic Evidence = A Duty to Defend

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[2] 292 Md. 187, 193-94, 438 A.2d 282, 285 (1981).
[3] *Sheets v. Brethren Mut. Ins. Co.*, 342 Md. 634, 643, 679 A.2d 540, 544 (1996) (internal citations omitted).
[4] *Aetna Cas. & Sur. Co. v. Cochran*, 337 Md. 98, 108, 651 A.2d 859, 864 (1995).
[5] *Walk v. Hartford Cas. Ins. Co.*, 381 Md. 1, 21-22, 852 A.2d 198, 210 (2004) (quoting *Reames v. State Farm Fire & Cas. Ins.,* 111 Md. App. 546, 561, 683 A.2d 179, 186 (1996), *cert. denied*, 344 Md. 329, 686 A.2d 635 (1996)).
[6] *Cochran*, 337 Md. at 107, 651 A.2d at 863-64.
[7] *S. Md. Agric. Ass'n v. Bituminous Cas. Corp.*, 539 F. Supp. 1295, 1304 (D. Md. 1982); *Harford Mut. Ins. v. Jacobson*, 73 Md. App. 670, 678, 536 A.2d 120, 124, *cert. denied*, 312 Md. 601, 541 A.2d 964 (1988).
[8] *Cochran*, 337 Md. at 107-108, 651 A.2d at 864 (citing *Brohawn,* 276 Md. at 408, 347 A.2d at 850); *Balt. Gas & Electric Co. v. Commercial Union Ins. Co*., 113 Md. App. 540, 567, 688 A.2d 496, 509 (1997).
[9] *Ohio Cas. Ins. Co. v. Lee*, 62 Md. App. 176, 488 A.2d 988, *cert. denied*, 303 Md. 471, 494 A.2d 939 (1985).
[10] *N. Ins. Co. of N.Y. v. Balt. Bus. Commc'ns, Inc*., 68 F. App'x 414, 420 (4th Cir. 2003).
[11] *Universal Underwriters Ins. Co. v. Lowe*, 135 Md. App. 122, 151, 761 A.2d 997, 1012 (2000).

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A second use of extrinsic evidence is where the policy terms are vague and ambiguous. There, extrinsic and parol evidence may be considered to ascertain the intentions of the parties.[12] If the policy terms remain ambiguous, they "will be construed liberally in favor of the insured and against the insurer as drafter of the instrument."[13]

D. Mixed Actions

The "mixed action" rule requires insurers to defend all counts of a multi-count complaint, even if only one claim is potentially covered by the policy.[14] Where there is a common core of facts or events giving rise to covered and non-covered injuries or claims under different legal theories, allocation is not permitted. Nor is there a right of allocation for defense costs incurred defending a non-covered claim where those costs were also necessary to defend a covered claim.[15] There is a limited and rarely applied exception to this rule that permits defense costs to be apportioned when it is easy to do so.[16]

In some states, the insurer may recoup the cost of defense if it turns out the defended counts were not covered.[17] This issue has not been addressed by the Maryland appellate courts. However, the Fourth Circuit, applying Maryland law, has predicted that there is no right to recoupment.[18]

E. Every Story Has a Beginning and an End

For occurrence policies, the duty to defend attaches when the occurrence happens.[19] Under claims-made policies, the duty to defend attaches when the claim is made during the policy period.[20]

The duty to notify is not a condition precedent, but a mere covenant due to Maryland's notice-prejudice statute.[21] The duty to defend is not breached until after the insurer receives notice of the event and the insurer unjustifiably declines to fulfill its obligations.[22] Tender need not be by the insured, but may be made by another on the insured's behalf to trigger a duty to defend.[23]

The duty to defend is a continuing one that extends to an appeal as long as reasonable grounds to appeal exist.[24] The duty to defend terminates when the claimant's "claim may be

[12] *Sullins v. Allstate Ins. Co.*, 340 Md. 503, 508-510, 667 A.2d 617, 619 (1995).
[13] *Megonnell v. U.S. Auto. Ass'n,* 368 Md. 633, 655-56, 796 A.2d 758, 772 (2002).
[14] *Utica Mut. Ins. Co. v. Miller*, 130 Md. App. 373, 383, 746 A.2d 935, 940 (2000), *cert. denied*, 359 Md. 31, 753 A.2d 3 (2000) (quoting *S. Md. Agric. Ass'n*, 539 F. Supp. at 1299).
[15] *Fed. Realty Inv. Trust v. Pac. Ins. Co.*, 760 F. Supp. 533, 536-37 (D. Md. 1991); *Cont'l Cas. Co. v. Bd. of Educ. of Charles Cnty.*, 302 Md. 516, 532, 489 A.2d 536, 544 (1985).
[16] *Loewenthal v. Sec. Ins. Co. of Hartford*, 50 Md. App. 112, 123 n.5, 436 A.2d 493, 499 n.5 (1990), *cert. denied*, 292 Md. 596 (1982).
[17] *See, e.g.*, *Buss v. Superior Court*, 16 Cal. 4th 35, 939 P. 2d 766 (Cal. 1997).
[18] *Perdue Farms, Inc. v. Travelers Cas. & Sur. Co. of Am.*, 448 F.3d 252, 258-59 (4th Cir. 2006).
[19] *Sherwood Brands Inc. v. Harford Accident & Indem. Co.*, 347 Md. 32, 41-42, 698 A.2d 1078, 1082-83 (1997).
[20] *Id*.
[21] *Id. See also* Md. Code Ann., Ins. § 19-110.
[22] *Sherwood Brands*, 347 Md. at 47, 698 A.2d at 1085-86.
[23] *Scottsdale Ins. Co. v. Am. Empire Surplus Lines Ins. Co.*, 791 F. Supp. 1079, 1084 (D. Md. 1992).
[24] *Commercial Union Ins. Co. v. Porter Hayden Co.*, 116 Md. App. 605, 654-55, 698 A.2d 1167, 1191 (1997), *vacated*, 339 Md. 150, 661 A.2d 691 (1995) (citing *Luppino v. Vigilant Ins. Co.*, 110 Md. App. 372, 382, 677 A.2d 617, 622 (1996), *aff'd*, 352 Md. 481, 723 A.2d 14 (1999)).

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confined to non-covered allegations."[25] The duty to defend also terminates when the policy limits are exhausted.[26] If there is no duty to defend, there is no duty to indemnify.[27]

F. Better Late Than Never—Insurer's Liability For Pre-Tender Defense Costs

Maryland, unlike virtually every other state, requires insurers to reimburse insureds for pre-notice defense costs unless it can show prejudice as a result of the delay.[28] The Court of Appeals set forth several factors for determining whether the insurer was prejudiced by the delay; *i.e.:* (1) was it reasonable for the insured to have incurred the expense; (2) was the expense reasonable; and (3) did the expense materially exceed what the insurer would likely have incurred had the notice been given earlier?[29] For example, a rate may be reasonable yet materially in excess of a rate a specific insurer has negotiated with competent counsel.[30] Each of these factors goes to the amount of defense costs, not liability for defense costs.

G. Court Actions, Administrative Actions, Judicially Created Trusts -What Type of Proceedings Must be Defended?

The Maryland Court of Appeals has not addressed directly the type of proceeding a liability insurer must defend. It appears that the duty may encompass administrative and some non-traditional proceedings, such as claims filed in judicially created trusts.[31]

H. Allocation of the Duty to Defend Among Multiple Insurers

Trouble shared is trouble halved. -- Sayers, Dorothy L.

Where two or more insurers cover the same policy period, defense costs are shared the same way as indemnity; *i.e*. pursuant to the "other insurance" provisions.[32] How consecutive insurers share the cost of defense is unresolved; however, it is likely to follow indemnity, which is shared on a time-on-the-risk basis.[33]

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[25] *Balt. Gas & Electric*, 113 Md. App. at 572, 688 A.2d at 511-12.

[26] *Griffith Energy Servs., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 224 Md. App. 252, 284-85, 120 A.3d 808, 827 (2015) (dicta).

[27] *Nautilus Ins. Co. v. REMAC Am., Inc.*, 956 F. Supp. 2d 674, 681-82 (D. Md. 2013).

[28] *Sherwood Brands*, 347 Md. at 45, 698 A.2d at 1084.

[29] *Id.* at 48-49, 698 A.2d at 1086.

[30] *Id.* at 49 n.7, 698 A.2d at 1086 n.7.

[31] *See*, *e.g.*, *Bausch & Lomb, Inc. v. Utica Mut. Ins. Co.*, 330 Md. 758, 625 A.2d 1021 (1993) (duty to indemnify cost of complying with administrative directive prior to legal proceeding; *a fortiori,* there is a duty to defend); *Liberty Mut. Ins. Co. v. Black & Decker Corp.*, 2005 WL 102964 (D. Mass. Jan. 13, 2005) (applying Maryland law) (pre-suit letter may trigger duty to defend); *Nat'l Union Fire Ins. Co. of Pittsburgh, Pa. v. Porter Hayden Co.*, 408 B.R. 66 (D. Md. 2009) ("suit" encompassed claims filed in Asbestos Bodily Injury Trust). *See also ACE Am. Ins. Co. v. Ascend One Corp.*, 570 F. Supp. 2d 789 (D. Md. 2008) (where policy terms include the defense of administrative or regulatory investigations there is a duty to defend).

[32] *See Ryder Truck Rental, Inc. v. Schapiro & Whitehouse, Inc.*, 259 Md. 354, 364-65, 269 A.2d 826, 831-32 (1970); *Centennial Ins. Co. v. State Farm Mut. Auto. Ins. Co.*, 71 Md. App. 152, 164, 524 A.2d 110, 116 (1987), *cert. denied,* 310 Md. 491, 530 A.2d 273 (1987).

[33] *Mayor & City Council of Balt. v. Utica Mut. Ins. Co.*, 145 Md. App. 256, 302-03, 802 A.2d 1070, 1097-98 (2002), *cert. granted*, 371 Md. 613, 810 A.2d 961 (2002), *appeal dismissed*, 374 Md. 81, 821 A.2d 369 (2003).

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I. Reservations of Rights and the Right to Independent Counsel

A reservation of rights letter is the insurer's first impression of the coverage issues that may arise between it and its insured. The letter informs an insured that a defense is provided subject to certain specified issues. The scope of coverage is not expanded by failure to include them in a reservation of rights letter.[34] However, conditions subsequent, such as late notice or failure to cooperate, may be waived.[35] Nonetheless, a reservation of rights letter should include all policy language and facts that may serve as the basis for a denial of coverage.

There is a right to independent counsel when there is a conflict of interest in the defense of the action. Maryland follows the dual client approach, where counsel represents both the insured and the insurer.[36] This dual representation presents problems where there is a conflict of interest. Where there is a conflict of interest in the defense of the case, such as where the facts to be adjudicated in the lawsuit will also determine coverage, the insured has the right to independent counsel.[37]

Where the claimant alleges both covered and non-covered counts, the insured and the insurer have diametrically opposed interests. The insurer's interest is to establish non-coverage and the insured's interest is to establish coverage. This is a type of conflict of interest where the insurer must allow the insured to choose independent counsel. The seminal case on this point in Maryland is *Brohawn v. Transamerica Insurance Company*,[38] where the complaint alleged negligence and assault (an intentional tort) in the alternative. The insured had previously pled guilty to assault charges. The Court reasoned that the insurer's selected counsel could defend on the basis that the guilty plea was an admission that the injuries were caused by an intentional act. This could result in a verdict against the insured on the non-covered intentional injury count and a dismissal of the negligence count. The *Brohawn* Court recognized that the rights of an insured could be adequately protected by the duties imposed upon the attorney by the Cannons of Professional Responsibility. However, the Court held:

> that an insured is not deprived of his contractual right to have a defense provided by the insurer when a conflict of interest between the two arises under circumstances like those in this case. When such a conflict of interest arises, the insured must be informed of the nature of the conflict and given the right either to accept an independent attorney selected by the insurer or to select an attorney himself to conduct his defense. If the insured elects to choose his own attorney, the insurer must assume the reasonable costs of the defense provided.[39]

Two federal district court judges applying Maryland law have found the requirement of independent counsel was fulfilled where the insurer-appointed panel counsel: (1) was instructed by the insurer to represent *only* the interests of the insured; (2) was at no time also representing the insurer in the case; and (3) had an ethical responsibility to

[34] *Creveling v. GEICO*, 376 Md. 72, 97-98, 828 A.2d 229, 243-44 (2003).
[35] *Id*.
[36] *See Fid. & Cas. Co. of N.Y. v. McConnaughy*, 228 Md. 1, 10, 179 A.2d 117, 121 (1962).
[37] *Roussos v. Allstate Ins. Co.*, 104 Md. App. 80, 90, 655 A.2d 40, 44 (1995), *cert. denied*, 339 Md. 355, 663 A.2d 73 (1995), *cert. denied*, 517 U.S. 1107 (1996).
[38] 276 Md. 396, 347 A.2d 842 (1975).
[39] *Id.* at 414-15, 347 A.2d. at 854.

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work only on behalf of his client, and no conflict of interest was created.[40]

A conflict as to how the case should be defended strategically does not give rise to a right to independent counsel.[41] Nor does a claim in excess of the policy limits.[42] Further, an insurer's rejection of an offer to settle within the policy limits does not automatically create a conflict.[43]

The insurer must assume the *reasonable* costs of defense by an independent counsel where required due to a conflict between the insurer and the insured.[44] The courts applying Maryland law have not examined what constitutes reasonable attorneys' fees.

J. Insurer's Risk in Failing to Defend.

Where an insurer breaches its obligation to defend, it is liable for the damages, including attorneys' fees, incurred by the insured as a result of the breach.[45] These attorneys' fees may be incurred in defending against the underlying tort claim or in a declaratory judgment action to determine coverage.[46]

An insurer that mistakenly refuses to defend is not estopped from denying its duty to indemnify.[47] If it is found to cover the loss, it is bound by the judgment.[48] Moreover, it does not give rise to a tort action for bad faith.[49]

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[40] *Driggs Corp. v. Pa. Mfrs. Ass'n Ins. Co.*, 3 F. Supp. 2d 657, 658-59 (D. Md. 1998), *aff'd*, 181 F.3d 87 (4th Cir. 1999); *Cardin v. Pac. Emps. Ins. Co.*, 745 F. Supp. 330, 336-38 (D. Md. 1990).
[41] *Nationwide Mut. Ins. Co. v. Webb*, 291 Md. 721, 741, 436 A.2d 465 (1981); *Roussos*, 104 Md. App. at 89-90, 655 A.2d at 44.
[42] *Id.*
[43] *Allstate Ins. Co. v Campbell*, 334 Md. 381, 396, 639 A.2d 652, 659 (1994).
[44] *Id.* at 392, 639 A.2d at 657.
[45] *Mesmer v. Md. Auto. Ins. Fund*, 353 Md. 241, 252, 725 A.2d 1053, 1058 (1999); *Litz v. State Farm Fire & Cas. Co.*, 346 Md. 217, 232-33, 695 A.2d 566, 573 (1997).
[46] *Id.*
[47] *Glens Falls Ins. Co. v. Am. Oil Co.*, 254 Md. 120, 136-37, 254 A.2d 658, 667 (1969).
[48] *Id.*
[49] *Mesmer*, 353 Md. at 252, 725 A.2d at 1058.