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Estoppel for Insurers Who Breach Their Duty to Defend: Answering the Critics, 50 J. Marshall L. Rev. 53 (2016)

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ESTOPPEL FOR INSURERS WHO BREACH THEIR DUTY TO DEFEND: ANSWERING THE CRITICS

STANLEY C. NARDONI*

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Courts in several states apply a strict rule to enforce the duty to defend found in most liability insurance policies. This rule encourages insurers to honor their defense obligations by extending liability for breaching a duty to defend beyond the standard compensatory damages of the insured's costs of defense. Under this rule, "an insurer will be precluded from denying coverage after it has unjustifiably refused to defend."¹ The insurer will be liable for

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1. Allan D. Windt, *Insurance Claims and Disputes: Representation of Insurance Companies and Insureds* § 4:37 (2015); see also John Dwight Ingram, *A Liability Insurer's Duty to Defend in Illinois*, 83 ILL. B.J. 195, 196 (1995) ("The consequences of wrongfully refusing to defend can be severe. The insurer can be liable for (1) the amount of a judgment against or a settlement made by the insured, (2) expenses and fees incurred by the insured in defending the suit, and (3) any additional damage traceable to its breach of the duty to defend."); BARRY R. OSTRAGER & THOMAS R. NEWMAN, *HANDBOOK ON INSURANCE COVERAGE DISPUTES* § 2.05[e] (18th ed. 2017) (The rule provides that "an insurer that wrongfully refuses to defend a policyholder

a settlement the insured reaches or a judgment against the insured, even where the judgment is based on a claim that falls outside its policy's coverage.² The rule is commonly called the "Illinois estoppel rule"³ because it developed in Illinois and the Illinois Supreme Court has traditionally been its "leading proponent."⁴

The rule recently received increased national attention following a decision of the New York Court of Appeals in which that court appeared to adopt it. In *K2 Investment Group, LLC v. American Guarantee & Liability Ins. Co.*,⁵ New York's highest court

may forfeit the right to assert policy defenses to coverage.").

2. ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW § 111[h][6] (5th ed. 2012) ("If the jury returns a verdict for the insured on the claim within coverage and a verdict for the plaintiff on the claim outside coverage, the insurer estopped to deny coverage for breaching the duty to defend will be required to indemnify the insured for liability outside the coverage."); Todd S. Schenk & Marcos G. Cancio, *Divide or Conquer? A Primer on Allocation Between Covered and Uncovered Claims and Insured and Uninsured Parties*, paper delivered at 2007 ABA Insurance Coverage Litigation Committee CLE Seminar March 1-3, 2007, at 10-11 ("[A]n insurer who wrongfully breaches its duty to defend does not merely bear the burden of proof on allocation, but is totally estopped from challenging the allocation of a settlement between covered and uncovered claims, and is liable for the entire settlement regardless of the nature of the underlying claims."), quoted in and paper available at Brief of Plaintiff-Appellee at 39-40, Appendix BA3-27, *BASF AG v. Great Am. Ins. Co.*, Nos. 06-3938 et al. (7th Cir. July 23, 2007).

3. Paula Litt, *Things Every Illinois Lawyer Should Know About the Duty to Defend*, 18-MAR CBA Rec. 34, 36 (Feb. Mar. 2004) ("The Illinois estoppel rule . . . applies to an insurer that fails to defend."); see, e.g., *Little v. USAA Cas. Ins. Co.*, No. 09-30948, 2010 WL 4909869, at *4 (5th Cir. Apr. 2, 2010) (stating that "[u]nder the 'Illinois Rule,' if a court determines that an insurer violated its duty to defend, the insurer is estopped from denying coverage."); see also *Blue Cross of Idaho Health Serv., Inc. v. Atl. Mut. Ins. Co.*, No. 1:09-CV-246-CWD, 2011 WL 162283, at *12 n.11 (D. Ida. Jan. 19, 2011) (holding that "Idaho law is in contrast to the Illinois rule, which applies the doctrine of estoppel once an insurer has breached its duty to defend."); Richard L. Neumeier, *Who Pays? When May the Defaulting Liability Insurer Contest the Subsequent Settlement of Claims Against its Insured?*, 26 WTR Brief 19, 19 (1997) ("[C]ases . . . purport to follow the 'Illinois Rule,' which holds that an insurer which wrongfully refuses to defend is 'estopped' from litigating indemnity issues."); see generally Stanley C. Nardoni & John S. Vishneski III, *The Illinois Estoppel Doctrine Revisited: How Promptly Must an Insurer Act*, 24 N. ILL. U. L. REV. 211 (2004) (discussing the scope of the estoppel rule as applied in Illinois); see also *Illinois School Dist. Agency v. Pac. Ins. Co.*, 471 F.3d 714, 720 (7th Cir. 2006) (referring to the rule as "contractual estoppel" to differentiate it from the general rule of equitable estoppel).

4. Windt, *supra* note 1, at § 4:37; see also Matthew Towns, *Having Failed to Defend, An Insurer Can Still Argue Lack of Coverage*, 68 MO. L. REV. 1001, 1011 (2003) (explaining that "Illinois courts do not hesitate to apply the doctrine of estoppel."); James A. Serritella, *Insurance Coverage Issues in Cases of Clergy Misconduct*, 39 CATH. LAW. 55, 71 (1999) ("If a policyholder can prove that the insurer breached its contractual duty to defend the policyholder against a third party's claim, then in a minority of jurisdictions most notably in Illinois the court would hold that the insurance company is estopped to deny coverage."); Todd J. Weiss, *A Natural Law Approach to Remedies for the Liability Insurer's Breach of the Duty to Defend: Is Estoppel of Coverage Defenses Just?*, 57 ALB. L. REV. 145, 149-54 (1993) (observing that the rule originated in Illinois and then "spread plague-like from state to state").

5. *K2 Inv. Group, LLC v. Am. Guarantee & Liab. Ins. Co.*, 993 N.E.2d 1249 (N.Y.),

held that an insurance company that disclaimed its duty to defend could litigate only the validity of that disclaimer, and if the “disclaimer is found bad, the insurance company must indemnify its insured for the resulting judgment, even if policy exclusions would otherwise have negated the duty to indemnify.”⁶ The court granted re-argument, however, and decided that although “[t]here is much to be said for the rule,” controlling New York precedent was to the contrary and had not proven “unworkable” or the cause of “significant injustice or hardship.”⁷

Public debate was also stimulated by the American Law Institute’s deliberations over whether to adopt the rule in the Restatement of the Law of Liability Insurance. A Discussion Draft of that Restatement espoused the rule in providing that “[d]amages for breach of the duty to defend include the amount of any judgment entered against the insured or the reasonable portion of a settlement entered into by or on behalf of the insured after breach, subject to the policy limits”⁸ A Tentative Draft then shifted to a more limited approach, stating that “[a]n insurer that breaches the duty to defend without a reasonable basis for its conduct must provide coverage for the legal action for which the defense was sought, notwithstanding any grounds for contesting coverage that the insurer could have preserved by providing a proper defense under a reservation of rights”⁹

Despite these favorable descriptions of the grounds for estoppel by the *K2* court and the American Law Institute, the rule has endured scathing criticism from other courts and several commentators. Courts rejecting the rule have maintained that it “subverts any meaningful distinction between the duty to defend and the separate duty to indemnify” for judgments or settlements, and often “serves no more than to punish the insurer for the breach of a contractual duty.”¹⁰ One commentator has said that “there is no legal theory that can be used to justify the estoppel rule,” and only a “handful of courts” apply it.¹¹

This article is intended to answer the critics. It begins by recounting the origin and scope of the rule in the state that developed it, Illinois. It then identifies the criticisms of the rule and provides responses demonstrating why they are unfounded, at least as to the way the rule is applied in Illinois. Among other things, the article points out that critics often overlook that under Illinois’

re-argument granted, 995 N.E.2d 1155 (N.Y. 2013), *vacated*, 6 N.E.3d 1117 (N.Y. 2014).

6. *Id.* at 1254.

7. *K2*, 6 N.E.3d at 1120.

8. RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 19 DD (2015).

9. RESTATEMENT OF THE LAW OF LIABILITY INSURANCE § 19 TD No 1 (2016).

10. *Sentinel Ins. Co., Ltd. v. First Ins. Co. of Haw., Ltd.*, 875 P.2d 894, 912 (Haw. 1994).

11. Windt, *supra* note 1, at § 4:37.

version of the rule, insurers enjoy a declaratory option that affords them a safe harbor from estoppel by seeking judicial guidance on their obligations. Critics also fail to take into account the rule's benefit for insurers that do satisfy their defense obligations, as such insurers often assert the rule against other carriers that disregarded their duties. The article concludes that under a fair analysis, the estoppel rule should be embraced rather than vilified.

I. THE DEVELOPMENT OF THE ESTOPPEL RULE IN ILLINOIS

Illinois, like other states, recognizes a broad duty to defend triggered whenever allegations asserted against a policyholder potentially state grounds for which the insurer has promised to indemnify.¹² In that regard, Illinois law provides:

If the facts alleged fall within, or potentially within, the policy's coverage, the insurer is obligated to defend its insured. This is true even if the allegations are groundless, false, or fraudulent, and even if only one of several theories of recovery alleged in the complaint falls within the potential coverage of the policy.¹³

An insurer may satisfy its defense obligation by defending under a reservation of rights to deny its duty to indemnify, but if the insurer doubts its defense duty was triggered, it may seek court guidance by filing a suit for a declaratory judgment to determine its obligations.¹⁴ An insurer that seeks a declaratory judgment on a timely basis can await instruction from the court before assuming the insured's defense.¹⁵

The estoppel rule determines what happens when underlying allegations are potentially within coverage and the insurer exercises neither option. An insurer that exercises neither option

12. See, e.g., *Valley Forge Ins. Co. v. Swiderski Elec. Inc.*, 860 N.E.2d 307, 314-15 (Ill. 2006) (concluding that "an insurer may not justifiably refuse to defend a lawsuit against its insured unless it is *clear* from the face of the underlying complaint that the allegations . . . fail to state facts that bring the case within, or potentially within, the coverage of the policy")(emphasis added); see also Karon O. Bowdre, "Litigation Insurance": *Consequences of an Insurance Company's Wrongful Refusal to Defend*, 44 *DRAKE L. REV.* 743, 748 (1996) (stating that it is a "universal principle" that "the duty to defend arises unconditionally upon the filing of a claim against the insured that is arguably within policy coverage regardless of the ultimate determination of liability under the policy").

13. *Swiderski*, 860 N.E.2d at 314-15 (citations omitted).

14. See *RLI Ins. Co. v. Ill. Nat'l. Ins. Co.*, 781 N.E.2d 321, 331 (Ill. App. Ct. 2002) (stating that the insurer may defend under a reservation of rights, seek a declaratory judgment "or both").

15. See *Those Certain Underwriters at Lloyd's v. Prof'l Underwriters Agency, Inc.*, 848 N.E.2d 597, 601 (Ill. App. Ct. 2006) (concluding that promptly suing for a declaratory judgment does not satisfy or eliminate the duty to defend but suspends "the insurer's duty to act on the duty to defend" pending instruction from the court as to whether a "duty to defend exists in the first place").

breaches its duty to defend, and becomes “estopped from raising policy defenses to coverage.”¹⁶ The rule ensures that “[t]he measure of damages for such a breach is generally the amount of the judgment against the insured or of a reasonable settlement, plus any expenses incurred.”¹⁷ The major cases that developed and established the principles of the rule are set out below.

A. Kinnan Barred a Breaching Insurer from Enforcing Policy Conditions

“The estoppel doctrine has deep roots in Illinois jurisprudence.”¹⁸ Those roots sprouted in 1925 in *Kinnan v. Charles B Hurst Co.*¹⁹ That Illinois Supreme Court case arose after John Kinnan sustained injuries while building a silo for his employer, the Charles B. Hurst Company.²⁰ Kinnan sued Hurst.²¹ Hurst’s insurer, Globe Indemnity Company, refused to defend, claiming Kinnan’s accident was not covered.²² Hurst was left to defend itself and lost.²³ Although Kinnan won a judgment against Hurst, Hurst lacked the funds to pay it.²⁴ Kinnan then pursued a claim against Globe.²⁵ In its defense, Globe maintained that based on its policy’s language, it could not be liable for a judgment Hurst did not pay.²⁶ Globe pointed out that although its insuring agreement included a promise to indemnify for damages due to bodily injuries, the agreement was subject to a condition that stated:

16. *Emp’rs Ins. of Wausau v. Ehlco Liquidating Trust*, 708 N.E.2d 1122, 1135, 1138 (Ill. 1999) (observing that the insured need not show prejudice); *see also* *Aetna Cas. & Sur. Co. v. Prestige Cas. Co.*, 553 N.E.2d 39, 42 (Ill. App. Ct. 1990) (holding that the insurer will be estopped even if another insurer assumed the policyholder’s defense because “[e]stoppel arises as a direct result of the insurer’s breach; such breach is not exonerated by a defense of the insured by another insurer”).

17. *Thornton v. Paul*, 384 N.E.2d 335, 340 (Ill. 1978), *overruled on other grounds*, *American Family Mut. Ins. Co. v. Savickas*, 739 N.E.2d 445 (Ill. 2000) (There will be no estoppel, however, “where the insurer was given no opportunity to defend; where there was no insurance policy in existence; and where, when the policy and the complaint are compared, there clearly was no coverage or potential for coverage”); *see, e.g.*, *Am. Safety Cas. Ins. Co. v. City of Waukegan*, 678 F.3d 475, 486 (7th Cir. 2012) (finding no estoppel where insurer was notified of underlying suit only a few days before it went to trial and thus “had so little time that, even acting diligently, it could not have supplied a defense or commenced a suit for a declaratory judgment before the underlying litigation reached judgment”).

18. *Ehlco*, 708 N.E.2d at 1135.

19. *Kinnan v. Charles B Hurst Co.*, 148 N.E. 12 (Ill. 1925).

20. *Id.* at 12.

21. *Id.* at 13.

22. *Id.*

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

[N]o action for the indemnity against loss provided for in insuring agreement I of this policy shall lie against the company, except for reimbursement of the amount of loss actually sustained and paid in money by the assured in full satisfaction of a judgment duly recovered against the assured after trial of the issue²⁷

The Illinois Supreme Court rejected Globe's argument.²⁸ It observed that apart from the duty to indemnify, the policy promised that if the insured was sued for an accident, Globe would "defend such suit, even if groundless, in the name and on behalf of the assured, unless or until the company shall elect to effect settlement thereof."²⁹ This duty to defend was a "fundamental obligation of the contract."³⁰ Globe's refusal to defend the Kinnan action, a suit for bodily injuries, breached its duty and released Hurst from having to pay the judgment as a condition to Globe's duty to indemnify. The court deemed Globe's repudiation of its defense obligation "a waiver of the performance by the assured of the conditions precedent to a recovery of the amount it would be entitled to if those conditions had been performed."³¹ The court observed that Globe was bound to defend the underlying suit unless and until it chose to settle the case.³²

Had it defended successfully, the assured would have been relieved of all liability. Had its defense been unsuccessful, the assured would have been able to require Globe to pay it the amount of the judgment to the extent of [Globe's policy indemnity limit of] \$5,000, with costs and interest. Having deprived the assured of this remedy, Globe became liable to the assured for its value—that is, for the amount which Globe would have been required to pay if it had performed its contract.³³

27. *Id.* at 13.

28. *Id.* at 14.

29. *Id.*

30. *Id.*

31. *Id.* The court pointed to a United States Supreme Court decision that held an insurer's "denial of all liability . . . and . . . refusal to defend . . . released the assured from its agreement not to settle any claim except at its own cost, and from the provision that no action should lie against the assurer unless for loss actually sustained and paid by the assured after a trial of the issue[.]" *Id.* at 15 (citing *St. Louis Dressed Beef Co. v. Md. Cas. Co.*, 201 U.S. 173, 177-78 (1906)). The *Kinnan* court said the New York Court of Appeals had likewise held that an insurer's breach of its duty to defend "release[s] the assured from the agreement not to settle claims without the consent of the company, and . . . waive[s] . . . the condition that the company should only be liable after the assured had paid the judgment rendered against him." *Id.* (citing *In re Empire Sur. Co.*, 108 N.E. 825, 827 (N.Y. 1915)).

32. *Id.*

33. *Id.* at 15 (For ease of understanding, in this quotation, "Globe" has been substituted for "the defendant in error.").

B. Sims Created the Modern Estoppel Rule by Extending Kinnan to Exclusions

Over time, *Kinnan* came to be viewed as stating a rule that not only excused an insured from having to perform conditions after the insurer breached its duty to defend, but one that precluded the insurer from arguing non-coverage entirely.³⁴ The ultimate expansion of *Kinnan* into the modern Illinois estoppel rule occurred in *Sims v. Illinois National Casualty Co.*³⁵ That case involved Illinois National's denial of coverage for a bodily injury suit against its insured, Virgil Sims, by a passenger in a truck Sims owned and drove. The denial was based on Illinois National's belief that the injured party, Ruark, was Sims' employee, and this employment relationship implicated an exclusion from coverage. Sims defended himself and incurred a judgment. Thereafter, acting on Ruark's behalf, Sims brought a garnishment action against Illinois National. Focusing on the allegations of Ruark's initial injury complaint, the Illinois Appellate Court determined that Illinois National breached its duty to defend Sims. The court noted that although the complaint alleged Ruark was a passenger in Sims' truck, there was "nothing in these allegations that would suggest an exclusion from coverage under the policy."³⁶ That these allegations left open a possibility that Ruark was Sims' employee did not avoid the duty to defend because "the insurer is obligated to

34. See *Wold ex rel. Wegener v. Glens Falls Indem. Co.*, 269 Ill. App. 407, 412 (1933) (relying on *Kinnan* in holding an insurer to the basis for the judgment entered in a suit it would not defend and concluding that an insurer that "repudiated its obligation by its failure to appear and take part in the defense of Wold in the original proceedings" was not "in a position to question the result of that action" in a subsequent garnishment action); see also *Gould v. Country Mut. Ins. Co.*, 185 N.E.2d 603, 615 (Ill. App. Ct. 1962), *overruled in part by* *Smith v. Andrews*, 203 N.E.2d 160 (Ill. App. Ct. 1964) (following *Wold* in holding an insurer that refused to defend a wrongful death action was conclusively bound by a judgment that found the insured liable for negligent conduct, which the policy covered, rather than willful and wanton conduct, which it excluded); see also *Rom v. Gephart*, 173 N.E.2d 828, 832 (Ill. App. Ct. 1961) (describing *Kinnan* as establishing a rule that estopped an insurer from contesting coverage). There, in stating what must have motivated an insurer that had initially refused to defend a case to step in after the insured sustained a default judgment and get that judgment vacated, the court described *Kinnan* as meaning that had the underlying "plaintiff recovered a judgment or had the insured made a settlement with the plaintiff, the insurance company, because of its failure to defend the suit, would have been estopped from asserting any defense as to payment based on non-coverage." *Rom*, 173 N.E.2d at 832.

35. *Sims v. Ill. Nat'l Cas. Co.*, 193 N.E.2d 123, 127-28 (Ill. App. Ct. 1963); see generally *Weiss*, *supra* note 4, at 149 (stating that "[t]he modern estoppel rule was first established in *Sims v. Illinois National Casualty Co.*"). Given the importance of this decision, the Illinois estoppel rule has sometimes been referred to as "the *Sims* rule." See, e.g., *Murphy v. Clancy*, 404 N.E.2d 287, 298 (Ill. App. Ct. 1980), *aff'd in part and rev'd in part sub nom.* *Murphy v. Urso*, 430 N.E.2d 1079 (Ill. 1981) (referring to the controlling precedent as the *Sims* rule).

36. *Sims*, 193 N.E.2d at 127.

defend if there is, *potentially*, a case under the complaint within the coverage of the policy.”³⁷

Quoting from a legal encyclopedia, the *Sims* court then observed:

By its unjustified refusal to defend an action against the insured, an automobile liability insurer becomes subject to the following new and positive obligations: (1) liability for the amount of the judgment rendered against the insured or of the settlement made by him; (2) liability for the expenses incurred by the insured in defending the suit; (3) liability for any additional damage traceable to its refusal to defend.

The first and most obvious of these positive obligations created by an insurer’s unjustified refusal to defend is its obligation to pay the amount of the judgment rendered against the insured or of any settlement made by the insured of the action brought against him by the injured party.³⁸

The court said that liability was “recognized as the rule in Illinois by” *Kinnan*.³⁹ It stated:

A careful reading of the [*Kinnan*] opinion will disclose the basic theory which is most important. It is, that when the insurer refused to defend the original *Kinnan* suit against Hurst Company, it breached its contract with Hurst Company. *At that time* a cause of action for breach of contract arose in favor of Hurst Company against the insurer. At that time the *liability* of the insurer, for the breach of contract, became fixed and certain although the amount of the liability may have been unliquidated. The *amount* of the liability becomes liquidated by the amount of the judgment obtained against the insured, because the amount of the judgment recovered can be said to be the natural consequence of the breach of the insurance contract by the insurer.⁴⁰

The *Sims* court said that what is “really meant” by the rule:

. . . is that the insurer has no right to insist that the insured be bound by the provisions of the insurance contract inuring to its benefit, i.e., the ‘Exclusions’ provisions, when it has already breached the contract by violating the provisions inuring to the benefit of the insured, i.e., the defense provisions. In this sense it may properly be said to be estopped.⁴¹

In light of this rule, the court decided that it made no difference whether there was evidence that Ruark actually was *Sims*’ employee. Given the estoppel to rely on policy exclusions, Ruark’s status was “immaterial and did not constitute a defense to

37. *Id.*

38. *Id.* at 127-28 (quoting 7 Am. Jur. 2d, Automobile Insurance § 167). According to one commentator, the American Jurisprudence article the *Sims* court quoted was “devoid of precedential support” for its statement. Weiss, *supra* note 4, at 151.

39. *Sims*, 193 N.E.2d at 128.

40. *Id.* at 128-29.

41. *Id.* at 129.

the garnishment action.”⁴² The court concluded that the insurer’s ability to seek guidance in the form of a declaratory judgment kept the rule fair to insurers:

In passing it might appear that the result reached announces a harsh rule so far as insurers are concerned. However, all authorities agree that quite often an insurer is faced with a dilemma as to whether to defend or to refuse to defend. In cases of doubt the answer is simple. It can (1) seek a declaratory judgment as to its obligations and rights or (2) defend under a reservation of rights.⁴³

C. The Illinois Supreme Court Made Sims Standard Illinois Law

The Illinois Supreme Court wholeheartedly embraced *Sims* in a series of decisions that began in the late 1970’s. In *Thornton v. Paul*,⁴⁴ injured plaintiff Thornton sued a bar and its owner for hitting him after he scuffled with other patrons. The bar’s insurer, Illinois Founders Insurance Company, refused to defend due to a policy assault and battery exclusion, though the complaint included allegations of negligence outside the exclusion. After Thornton won a default judgment and agreed to execute it from the insurer alone, he brought a garnishment action resulting in an order that Illinois Founders pay him the amount of the default judgment. In confronting the “basic issue” of whether Illinois Founders was “estopped from raising lack of coverage . . . because of its failure to defend the lawsuit,” the Illinois Supreme Court espoused the estoppel rule as formulated in *Sims*.⁴⁵ It stated:

When the insurer wrongfully refuses to defend a complaint which alleges facts within coverage, it is liable to the insured for breach of contract. The measure of damages for such a breach is generally the amount of the judgment against the insured or of a reasonable settlement, plus any expenses incurred.

Another major effect of the insurer’s wrongful failure to defend is to estop the insurer from later raising policy defenses or noncoverage in a subsequent action by the insured or by a judgment creditor in garnishment.⁴⁶

42. *Id.*

43. *Id.* at 130.

44. See generally *Thornton*, 384 N.E.2d at 335, *overruled in part* by Am. Family Mut. Ins. Co. v. Savickas, 739 N.E.2d 445 (Ill. 2000) (overruling *Thornton* concerning the impact of a criminal conviction in a civil case, but not on the Illinois estoppel rule).

45. *Thornton*, 384 N.E.2d at 337.

46. *Id.* at 340 (citations omitted). Apart from treatises, the supreme court cited *Kinnan*, *Sims*, and *Palmer v. Sunberg*, 217 N.E.2d 463 (Ill. App. Ct. 1966), which followed *Sims* in holding an automobile insurer liable for a default judgment because the insurer had refused to defend despite the possibility that the insured’s station wagon could be considered a non-owned vehicle so as to potentially fall within

Although acknowledging this was the general rule, the court drew a narrow exception for the facts of the case. It reasoned that the insurer's ability to avoid coverage if the insured was held liable for battery rather than negligence presented a conflict of interest, and in such a circumstance, an insurer "should not be obligated or permitted to participate in the defense of the case."⁴⁷ The insurer could not test coverage in that situation with a declaratory judgment because it would decide the issue in the underlying case, *i.e.*, whether the insured had committed an intentional tort or acted only negligently; that issue had to await resolution in the tort case itself.⁴⁸ Under those facts, "the insurer's failure to defend should not estop it from raising the defense of noncoverage in the garnishment action."⁴⁹

The *Thornton* court stressed that its decision was "not a repudiation of the holding of *Sims*, but . . . a narrow exception to that holding applicable only under conditions such as are presented in the present case."⁵⁰ Though there would be no estoppel, the insurer would not escape funding a defense because its defense "obligation must be satisfied by reimbursing the insureds for the costs thereof."⁵¹ The Illinois Supreme Court reaffirmed *Thornton* three years later in *Murphy v. Urso*,⁵² again holding an insurer's conflict of interest avoided estoppel. By then, the court felt the *Sims* rule was sufficiently established as to be known as "the familiar general rule of estoppel."⁵³

In *Clemmons v. Travelers Insurance Co.*, the Illinois Supreme Court held that *Sims*' estoppel rule applies to putative insureds as well as named insureds.⁵⁴ The court held an insurer breached its duty to defend a suit with allegations that left open the possibility that a person was driving a car with the named insured's permission so as to qualify as an insured under the named insured's policy.⁵⁵ The insurer was precluded from disputing coverage for a judgment against the putative insured based on evidence that weighed against his insured status because the "insurer failed to act equitably, that is, failed to defend under a reservation of rights or to bring a declaratory judgment action to determine whether there was coverage under the policy."⁵⁶ In *Conway v. Country Casualty Insurance Co.*, the Illinois Supreme Court again reaffirmed its

coverage and raise a duty to defend.

47. *Thornton*, 384 N.E.2d at 343.

48. *Id.* at 345-46.

49. *Id.* at 345.

50. *Id.* at 346.

51. *Id.* at 348.

52. *Urso*, 430 N.E.2d at 1079.

53. *Id.* at 1082.

54. *Clemmons v. Travelers Ins. Co.*, 430 N.E.2d 1104 (Ill. 1981).

55. *Id.* at 1109.

56. *Id.*

reliance on *Sims* but held that an estopped insurer's liability for a judgment or settlement is restricted to its policy limits unless "the insurer acted in bad faith by refusing to defend its insured."⁵⁷

In *Waste Mgmt, Inc. v. Int'l Surplus Lines Ins. Co.*, the Illinois Supreme Court discussed *Sims*' declaratory option.⁵⁸ It explained that where an insurer denies coverage in the form of a declaratory judgment action or in a letter "which precedes a promptly filed complaint for declaratory action, [its denial] is not tantamount to repudiation of the policy obligations."⁵⁹ Accordingly, such a denial cannot operate as a breach of the duty to defend that estops the insurer from disputing coverage.⁶⁰ In a subsequent decision, *State Farm Fire & Casualty Co. v. Martin*, the court held that an insurer exercising the declaratory option without assuming the defense "will not be estopped from denying coverage merely because the

57. *Conway v. Country Cas. Ins. Co.*, 442 N.E.2d 245, 249 (Ill. 1982). Illinois has, on the other hand, long followed and applied the generally accepted law that an insurer can be liable beyond its limits when it has unreasonably refused a settlement demand within policy limits. *See, e.g.*, *Olympia Fields Country Club v. Bankers Indem. Ins. Co.*, 60 N.E.2d 896, 901 (Ill. App. Ct. 1945) (stating that "an insurer may be liable for the entire judgment recovered against an insured although the judgment exceeds [the policy limits] . . . if the insurer be guilty of fraudulent conduct or a lack of good faith in refusing to settle."). This liability does not stem from the Illinois estoppel rule, but from a duty arising from the insurer's policy right to control settlement decisions. *Cramer v. Ins. Exch. Agency*, 675 N.E.2d 897, 903 (Ill. 1996).

58. *Waste Mgmt., Inc. v. Int'l Surplus Lines Ins. Co.*, 579 N.E.2d 322, 334 (Ill. 1991).

59. *Id.* Although *Waste Management* spoke of the need for a prompt declaratory action, precisely how quickly the declaratory option must be pursued is unsettled under Illinois Supreme Court decisions, though waiting until the underlying case is over "is untimely as a matter of law." *Ehlco*, 708 N.E.2d at 1138. Most recent decisions by other courts have subscribed to the test established in *Korte Construction Co. v. American States Ins. Co.*, which requires the insurer to defend or seek declaratory relief "within a reasonable time of a demand by the insured" for a defense to avoid estoppel. *Korte Constr. Co. v. Am. States Ins. Co.*, 750 N.E.2d 764, 770 (Ill. App. Ct. 2001). *See, e.g.*, *Elec. Ins. Co. v. Nat'l Union Fire Ins. Co. of Pittsburgh*, 346 F. Supp. 2d 958, 968 n.10 (N.D. Ill. 2004) (stating that "[w]ere the Illinois Supreme Court to address this issue," it would adopt Korte's reasonable time test.); *see also* *Uhlich Children's Advantage Network v. Nat'l Union Fire Co. of Pittsburgh, Pa.*, 929 N.E.2d 531, 543 (Ill. App. Ct. 2010) (holding that "[f]orcing the insureds to file a declaratory action two years after defendants denied their claim did not constitute 'a reasonable time of a demand by the insured.'" (quoting Korte); *see also* *State Auto. Mut. Ins. Co. v. Kingsport Dev., LLC*, 846 N.E.2d 974, 987 (Ill. App. Ct. 2006) (concluding that "the 'reasonable time' test is the best approach"); *see also* *L.A. Connection v. Penn-America Ins. Co.*, 843 N.E.2d 427, 433 (Ill. App. Ct. 2006) (agreeing "that the reasonable time test . . . best serves the goal of the estoppel doctrine . . .").

60. *Waste Mgmt.*, 579 N.E.2d at 335. In describing estoppel, the court said that while the rule applies where the insurer has breached its duty to defend, "[t]he rule is likewise applicable to cases where the insurer's duty is to indemnify." *Id.* The case involved environmental impairment liability insurance policies that "provide[d] indemnity to insureds for defense costs for" certain types of claims. *Id.* at 324-25. Thus, the court's reference to the rule as applying to a duty of indemnity may have meant policies requiring indemnification of defense costs as well as those providing for a duty to assume an insured's defense.

underlying case proceeds to judgment before the declaratory judgment action is resolved.”⁶¹ A contrary rule would render the declaratory option “illusory.”⁶²

The Illinois Supreme Court cited *Sims* again in *Employers Ins. of Wausau v. Ehlco Liquidating Trust*.⁶³ The court held that an insurer’s failure to defend an underlying suit with allegations potentially within the coverage of its policy estopped it from disputing its duty after the underlying suit settled on the ground that the insured had failed to comply with policy notice provisions.⁶⁴ The court refused to draw an exception to the estoppel rule for late notice defenses because it “would seriously undermine the effectiveness of the estoppel doctrine and its intended enforcement of the duty to defend.”⁶⁵ The court recounted that the only exception it had ever drawn was the one that applied where “a serious conflict of interest” precluded “the insurer from assuming the insured’s defense,” but those circumstances still required the insurer to satisfy its defense obligation by reimbursing the insured’s defense costs.⁶⁶ The Illinois Supreme Court affirmed the *Ehlco* appellate court’s holding that even if an insurer has such a conflict of interest, it will be estopped if it fails to provide the insured with “a defense by reimbursing it for costs as they were incurred.”⁶⁷

In its most recent estoppel decision, *Guillen v. Potomac Insurance Co. of Illinois*,⁶⁸ the Illinois Supreme Court judged estoppel applied where, after the insurer wrongfully refused to defend, the policyholder and the injured party reached a settlement under an agreement that assigned rights to the injured party under a promise to collect from the insurer alone. To avoid any chance of collusion, however, the injured party would have to show the settlement amount was “reasonable under the circumstances” to recover.⁶⁹

61. State Farm Fire & Cas. Co. v. Martin, 710 N.E.2d 1228, 1231-32 (Ill. 1999).

62. *Id.*

63. *Ehlco*, 708 N.E.2d at 1122, 1135.

64. *Id.* at 1134-35.

65. *Id.* at 1136.

66. *Id.* at 1135, 1137.

67. *Id.* at 1137. The Illinois Supreme Court observed that Wausau had not contested this holding in its briefs apart from raising an unsupported factual challenge to whether Ehlco had submitted its bills. *Id.* The Illinois Supreme Court did not, however, say waiver was the only basis for its holding. *Id.* Moreover, the decision to impose estoppel despite a conflict where the insurer fails to reimburse on an ongoing basis was not novel. *See Ins. Co. of Pa. v. Protective Ins. Co.*, 592 N.E.2d 117, 123 (Ill. App. Ct. 1992) (deciding that an insurer that failed to reimburse defense costs as insured incurred them was estopped despite claim of a conflict of interest). To the best of my research, no Illinois decision has ruled contrary to *Ins. Co. of Pa.* or even expressed disagreement with that case’s holding.

68. *Guillen v. Potomac Ins. Co. of Ill.*, 785 N.E.2d 1 (Ill. 2003).

69. *Id.* at 14-15.

II. THE ESTOPPEL RULE HAS BEEN CRITICIZED BY COURTS AND COMMENTATORS

Although many states follow the rule that an insurer's breach of its obligations releases the insured from satisfying policy conditions as applied in *Kinnan*,⁷⁰ many have refused to extend that principle to hold that breaching a duty to defend will preclude the insurer from contesting coverage entirely as the *Sims* court did.⁷¹ For example, in *Servidone Construction Corp. v. Security Insurance Co.*,⁷² the New York Court of Appeals held that where an insurer breaches its duty to defend and the insured thereafter settles the action against it, the insurer need not indemnify for the settlement "irrespective of actual coverage," if the insurer can "establish that the loss was not covered by the policy." The court did not discuss cases from outside New York, such as *Sims*, but it did reject the idea that breaching the duty to defend could impact the duty to indemnify.⁷³ The *Servidone* court reasoned that the duty to indemnify is "distinctly different" from the duty to defend.⁷⁴ "The duty to defend is measured against the allegations of pleadings but the duty to pay is determined by the actual basis for the insured's liability to a third person."⁷⁵ Permitting breach of the defense duty

70. *See, e.g.*, *Goerss v. Indem. Co. of Am.*, 3 S.W.2d 272, 273-75 (Mo. App. Ct. 1928) (holding that an insurer that "refused to defend the action brought by the plaintiff against the insured and disclaimed all liability under the policy" could not rely on policy provision against suing insurer until insured has paid judgment against him); *see also* *Garcia v. Underwriters at Lloyd's London*, 156 P.3d 712, 723 (N.M. Ct. App. 2007), *aff'd*, 182 P.3d 113 (N.M. 2008) (quoting *State Farm Fire & Cas. Co. v. Price*, 684 P.2d 524, 531 (N.M. Ct. App. 1984)) (deciding that "an insurer that fails to defend after a demand 'suffers serious consequences' including 'loss of the right to claim that the insured breached policy provisions.'").

71. *See, e.g.*, *U.S. Bank Nat'l Ass'n v. Fed. Ins. Co.*, No. 10-CV-0266-W-HFS, 2010 WL 3928123, at *4 (W.D. Mo. Oct. 4, 2010) (citations omitted) (stating that "[e]ven assuming a duty to pay defense costs, and an anticipatory breach of that obligation, I am satisfied this would not disable the insurers from relying on the limitations of coverage that were not impacted by the breach. Estoppel to rely on policy coverage terms has not been used in Missouri as a consequence of breach."), *aff'd*, 664 F.3d 693, 701 (8th Cir. 2011) (stating that "Missouri does not allow estoppel to extend coverage over otherwise uncovered claims."); *see also* *Aselco, Inc. v. Hartford Ins. Group*, 21 P.3d 1011, 1020 (Kan. Ct. App. 2001) (stating that "we believe the cases decided to this point mean our Kansas Supreme Court would not adopt a bright line rule that insurers who fail to provide a defense and reserve their rights are inevitably equitably estopped from raising their coverage defenses."); *see also* *Enserch Corp. v. Shand Morahan & Co.*, 952 F.2d 1485, 1493 (5th Cir. 1992) (applying Texas law and stating that "[a]n insurer that breaches its duty to defend, however, does not necessarily owe its insured complete indemnification for a settlement the insured reached on its own.").

72. *Servidone Constr. Corp. v. Sec. Ins. Co.*, 477 N.E.2d 441, 442 (N.Y. 1985).

73. *Id.* at 444.

74. *Id.*

75. *Id.* (citation omitted).

to determine the duty to indemnify would improperly enlarge “the bargained-for coverage as a penalty.”⁷⁶

The Supreme Judicial Court of Massachusetts agreed with this view in *Polaroid Corp. v. Travelers Indemnity Co.*⁷⁷ The *Polaroid* court rejected the insured’s argument that “if an insurer in breach of its obligation to defend a claim declines to defend that claim, the insurer must pay the amount of any reasonable settlement that the insured makes, without regard to whether the claim was one for which coverage was provided.”⁷⁸ The court observed that in the case before it, the insurers “demonstrated conclusively that the [underlying] Cannons claims were not covered under the policies issued to Polaroid.”⁷⁹ The court reasoned that it was concerned with a claim for contract damages because of a breach of the duty to defend.⁸⁰ Such damages are those that could not be reasonably prevented and arise naturally from the breach. Given that Polaroid made “no claim that it was forced to settle the Cannons claims because its insurers had declined to defend those claims,” the non-covered settlement could not “be the result of a breach of the duty to defend.”⁸¹ The court declined to follow the Illinois Supreme Court’s *Clemmons* decision, as well as the estoppel cases issued by courts in other states.⁸²

In *Hirst v. St. Paul Fire & Marine Insurance Co.*, Idaho’s Court of Appeals also declined “to adopt the Illinois rule.”⁸³ The court questioned “the propriety of utilizing a form of estoppel as a punitive measure against an insurer for breach of a contractual duty to defend.”⁸⁴ The court believed instead that “the sanctions for that breach should be governed by ordinary principles of contract law,” and in Idaho, damages are awarded “to fully recompense the non-breaching party for its losses sustained because of the breach, not to punish the breaching party.”⁸⁵ The damages stemming from breaching the defense obligation are simply the attorney fees and costs incurred by the insured in defending himself.⁸⁶ Idaho’s Supreme Court later agreed with the *Hirst* court’s rejection of the

76. *Id.* As noted previously, the New York Court of Appeals held that its precedent precluded adopting the estoppel rule. *K2*, 6 N.E.3d at 1119-20. *Servidone* was the case that established that precedent. *Id.*

77. *Polaroid Corp. v. Travelers Indem. Co.*, 610 N.E.2d 912 (Mass. 1993).

78. *Id.* at 920.

79. *Id.*

80. *Id.* at 921.

81. *Id.* at 921-22.

82. *Id.* at 921.

83. *Hirst v. St. Paul Fire & Marine Ins. Co.*, 683 P.2d 440, 447 (Idaho Ct. App. 1984).

84. *Id.*

85. *Id.*

86. *Id.*

Illinois Rule “as a punitive measure for breach of a contractual duty.”⁸⁷

The Supreme Court of Hawaii followed *Servidone*, *Hirst* and *Polaroid* in explicitly rejecting Illinois’ estoppel rule in *Sentinel Insurance Co. v. First Insurance Co. of Hawai’i Ltd.*⁸⁸ According to the *Sentinel* court:

[A] blanket application of coverage by waiver or estoppel, based upon the failure to provide a defense, subverts any meaningful distinction between the duty to defend and the separate duty to indemnify and, in many cases, serves no more than to punish the insurer for the breach of a contractual duty.⁸⁹

The Hawaii court stated that the decisions following the estoppel rule “evinced a policy concern that, without it, insurers might otherwise be encouraged to disavow their responsibility to defend” with nothing to lose.⁹⁰ The court felt this justification was “tenuous” given that that an insurer that refuses to defend forfeits any right to control the defense costs and strategy, including the right to compel the insured’s cooperation in the defense of the claims, waives its right to approve any settlement, and exposes itself to liability for “all reasonable defense fees and costs” if it loses its claim of no duty to defend.⁹¹

The rationale of the *Servidone*, *Hirst*, *Polaroid*, and *Sentinel* cases is echoed in the decisions of numerous other courts. Many have stressed that the duties to defend and indemnify are separate

87. See *Deluna v. State Farm Fire & Cas. Co.*, 233 P.3d 12, 17 (Idaho 2008) (stating “[w]e agree with the Court of Appeals’ holding. The proper measure of damages for breach of a contractual duty, including an insurer’s duty to defend, is contract damages. In a situation such as this, damages would include attorney fees and costs for defending the claim, together with any other damages shown to be a result of the breach.”); see also *Blue Cross of Idaho Health Serv.*, 2011 WL 162283, at *12 n.11 (determining that, “Idaho law is in contrast to the Illinois rule, which applies the doctrine of estoppel once an insurer has breached its duty to defend.”).

88. *Sentinel*, 875 P.2d at 894.

89. *Id.* at 912.

90. *Id.*

91. *Id.* at 913.

and distinct when refusing to tie a breach of the duty to defend to liability for indemnification.⁹² Others have simply said the Illinois rule conflicts with their state's insurance law.⁹³

92. *Signature Dev. Cos. v. Royal Ins. Co. of Am.*, 230 F. 3d 1215, 1222 (10th Cir. 2000) (holding "Colorado will likely join in the majority of jurisdictions in holding that an insurer who breaches its duty to defend may contest coverage. This approach is consistent with the doctrinal distinction between the duty to defend and the separate duty to indemnify."); *see also* *Ala. Hosp. Ass'n Trust v. Mut. Assur. Soc'y*, 538 So. 2d 1209, 1216 (Ala. 1989) (holding that "[a] failure of an insurer to defend a claim against an insured does not work an estoppel on the issue of coverage . . . 'We reject the proposition that an insurer's liability to pay for damages may stem from a breach of its duty to defend. The two duties are to that extent independent.'") (quoting *Ala. Farm Bureau Mut. Cas. Ins. Co. v. Moore*, 349 So. 2d 1113, 1116 (Ala. 1977)); *see also* *Quihuis v. State Farm Mut. Auto. Ins. Co.*, 334 P.3d 719, 728 (Ariz. 2014) (quoting *Sentinel* on the need to maintain a distinction between the duties to defend and indemnify in refusing to apply "issue preclusion to deprive an insurer of its coverage defense because the insurer allegedly breaches its duty to defend"); *see also* *Arceneaux v. Amstar Corp.*, 66 So. 3d 438, 450-52 (La. 2011) (deciding that the trial court erred in ruling that "Continental's breach of the duty to defend caused a waiver of the policy defenses and exclusions benefitting Continental, resulting in a finding that Continental was liable for the entire settlement amount." In those circumstances, "ordinary contract law principles" render the insurer "liable for the insured's reasonable defense costs," not "a windfall of potentially enormous profits, far beyond the natural consequences of the . . . breach . . ."); *see also* *Elliott v. Hanover Ins. Co.*, 711 A.2d 1310, 1313-14 (Me. 1998) (stating that "[w]e agree with the court's reasoning in *Polaroid* . . ."); *see also* *Ross v. Home Ins. Co.*, 773 A.2d 654, 658 (N.H. 2001) (observing that "while the duty to defend is broader than the duty to indemnify," breach is not a method to obtain coverage the insured did not buy.); *see also* *Nw. Pump Equip. Co. v. Am. States Ins. Co.*, 925 P.2d 1241, 1243 (Or. Ct. App. 1996) (stating that "the duty to defend is different from the duty to indemnify, and the breach of one does not, in and of itself, establish the breach of the other."); *see also* *Am. States Ins. Co. v. State Auto Ins. Co.*, 721 A.2d 56, 64 (Pa. Super. Ct. 1998) (ruling that "we will not adopt a blanket rule that if there is a breach of a duty to defend and a settlement, then it automatically requires the breaching insurer to indemnify. As stated above, a duty to indemnify requires an inquiry into whether there was actual coverage for the underlying claim."); *see also* *Utica Nat'l Ins. Co. v. Am. Indem. Co.*, 141 S.W.3d 198, 203 (Tex. 2004) (concluding that because the duties to defend and indemnify are distinct and separate, "[e]ven if a liability insurer breaches its duty to defend, the party seeking indemnity still bears the burden to prove coverage if the insurer contests it.").

93. *S. Guar. Ins. Co. v. Dowse*, 605 S.E.2d 27, 29 (Ga. 2004) ("By refusing to defend . . . [insurer] SGIC did not waive its right to contest its insured's assertion that the insurance policy provides coverage for the underlying claim."); *see also* *Fireman's Fund Ins. Co. v. Rairigh*, 475 A.2d 509, 514-15 (Md. Ct. Spec. App. 1984) (stating that "we believe that the Court of Appeals has rejected the line of cases" that follow "[t]he so called 'Illinois Rule'"); *see also* *St. Paul Ins. Co. v. Bischoff*, 389 N.W.2d 443, 444 (Mich. Ct. App. 1986) (stating that "INA argues that this Court should adopt the rule used by courts in Illinois and Connecticut, which provides that an insurer has no right to assert exclusion provisions once it has breached its duty to defend the insured. However, the Michigan decisions compel us to reject INA's arguments."); *Cf. Mesmer v. Md. Auto. Ins. Fund*, 725 A.2d 1053, 1064 (Md. 1999) (observing that "[t]here is utterly no support in our cases for the plaintiffs' argument that the damages for a liability insurer's breach of the promise to defend include the amount of the excess judgment. Instead, the damages for breach of the contractual duty to defend are limited to the insured's expenses").

Several commentators have joined in these criticisms. They have claimed that only “a few courts,” a mere “handful,” have accepted the estoppel rule, while the “vast majority of cases” have held against it.⁹⁴ Commentators have maintained that “the estoppel rule as applied by the *Sims* court contradicts the well-known principle that the duty to defend is independent of the duty to indemnify.”⁹⁵ They see “little intellectual justification for such [an] approach under the law involving damages for breach of contract.”⁹⁶ One has said that the theories courts that adopted the rule have advanced in support of their holdings do not stand up to analysis.⁹⁷ “First,” he states, “some have reasoned that, since the insurer has breached the insurance contract, the insured is no longer bound by the provisions of the contract.”⁹⁸ Although that commentator acknowledges that proposition “is true,” he points out that relieving the insured of future obligations under the policy, such as the duty to cooperate or refrain from effecting a settlement, “has nothing to do with whether the actions complained of or the injuries sustained by the party suing the insured are encompassed by the policy.”⁹⁹ He continues:

The second theory that has been advanced in support of precluding an insurer from denying coverage once it has unjustifiably refused to defend is that the insured would otherwise have the difficult burden of proving a causal relation between the insurer’s breach of contract and the subsequent judgment or settlement. The fact is, however, that there is almost never such a causal relation. It is less than logical, therefore, to hold insurers that have breached their duty to defend automatically liable for all judgments and settlements simply because, in certain highly unusual circumstances, it is possible that the insurer’s actions may have contributed to the entry or amount of a judgment or settlement.¹⁰⁰

94. Neumeier, *supra* note 3, at 19 (Only “a few courts have held that the insurer who wrongfully refuses to defend is liable for any ensuing judgment irrespective of policy exclusions or the policy limit”); *see also* Windt, *supra* note 1, at § 4.37 (stating that “[t]he vast majority of cases have properly held that an insurer’s unjustified refusal to defend does not estop it from later denying coverage under its duty to indemnify Nevertheless, a handful of courts have held that an insurer will be precluded from denying coverage after it has unjustifiably refused to defend.”).

95. *See* Weiss, *supra* note 4, at 157, 166 (concluding that the estoppel rule should be limited “to situations in which the insurer acts in bad faith in failing to defend . . .”).

96. Neumeier, *supra* note 3, at 19.

97. Windt, *supra* note 1, at § 4.37.

98. *Id.*

99. *Id.*

100. *Id.* (footnotes omitted) (concluding that the “better rule . . . is to award such consequential damages only when they can be proved by the insured,” and the most a court “dissatisfied with that rule” should do is “shift the burden of proof and require the insurer to demonstrate the absence of a causal relation between its breach of its duty to defend and the judgment or settlement.”).

“In short,” he states, “there is no legal theory that can be used to justify the estoppel rule.”¹⁰¹

The commentator suggests a form of bad faith liability as a better remedy. He concludes: “If an insurer wrongfully refuses to defend an insured, it should be liable for the damages that the insured thereby incurs, and if the refusal to defend is egregious, the insurer should be liable for the insured’s attorneys’ fees and possibly punitive damages.”¹⁰² Others have similarly suggested that barring insurers from contesting coverage for all breaches of their duty to defend unfairly grants “a windfall to policyholders who will receive indemnity coverage that they did not purchase.”¹⁰³

III. THE CRITICISMS OF THE RULE ARE FLAWED

A. *A Significant Number of States Follow the Estoppel Rule*

Contrary to descriptions by critics, a sizable number of courts have held in favor of the estoppel rule. Even before the Illinois Supreme Court endorsed the *Sims* holding, the Supreme Court of Connecticut espoused it in *Missionaries of the Company of Mary, Inc. v. Aetna Casualty & Surety Co.*¹⁰⁴ There, the insurer, Aetna, refused to defend a bodily injury suit because its investigation indicated that a provision of its policy that excluded injuries arising out of construction operations applied. The insured, Missionaries, defended itself and settled with the injured party, Stephen Shuhi. The Connecticut Supreme Court held the refusal to defend was wrongful because the complaint allegations did not trigger the exclusion provision of the policy. The court went on to ask: “What are the consequences of that breach?”¹⁰⁵ Aetna, the defendant, argued it could have no liability for the insured’s settlement because the evidence apart from the complaint allegations indicated that coverage was excluded. Citing *Sims* along with cases from other states, the Connecticut court rejected that position, stating:

The defendant having, in effect, waived the opportunity . . . to perform its contractual duty to defend under a reservation of its right . . . reason dictates that the defendant should reimburse the plaintiff for the full amount of the obligation reasonably incurred by it. The

101. *Id.*

102. *Id.*

103. Laura A. Foggan & Karen L. Toto, *The Draft ALI Restatement of the Law of Liability Insurance: Consequences of Breach of the Duty to Defend are not and Should not Become the Automatic Forfeiture of Coverage Defenses*, 68 RUTGERS U.L. REV. 65, 75 (2015).

104. *Missionaries of the Co. of Mary, Inc. v. Aetna Cas. & Sur. Co.*, 230 A.2d 21 (Conn. 1967).

105. *Id.* at 25.

defendant, after breaking the contract by its unqualified refusal to defend, should not thereafter be permitted to seek the protection of that contract in avoidance of its indemnity provisions. Nor should the defendant be permitted, by its breach of the contract, to cast upon the plaintiff the difficult burden of proving a causal relation between the defendant's breach of the duty to defend and the results which are claimed to have flowed from it. To do so would cast upon the insured not only the unpleasant but the extremely difficult burden of proof on the issue whether the defendant's attorneys, by superior skill and wisdom, could have produced a better result at less expense than that achieved by the plaintiff's counsel.

. . . Under all the circumstances, the plaintiff is entitled to recover of the defendant the amount of the settlement in the Shuhi case, together with the expenses and attorneys' fees incurred by it in defending the case, with interest.¹⁰⁶

The law established by *Missionaries* and subsequent cases has been summarized as follows:

[I]n Connecticut, the failure to defend when the allegations of a third party's complaint fall within the coverage of the policy results in the insurer's being liable for the entire judgment rendered against the insured, even though the policy or the facts ultimately demonstrate that no indemnity is due and owing.¹⁰⁷

If the insured settles the case the insurer refused to defend, on the other hand, the insurer will be held "liable for the portion of a pretrial settlement that may be reasonably allocated to allegations that form the basis of claims for which the insurer had an independent duty to defend"¹⁰⁸ Connecticut's highest court believes "that holding an insurer liable for the settlement of claims which it had no duty to defend is per se unreasonable" ¹⁰⁹ It thus permits insurers to "challenge the reasonableness of global settlements on the basis of the allocation of damages."¹¹⁰

106. *Id.* at 26 (citations omitted). The Connecticut Supreme Court cited *Sims* again, along with other Illinois cases, in reaffirming the rule of estoppel for insurers that breach their defense obligations in *Schurgast v. Schumann*, 242 A.2d 695, 704-05 (Conn. 1968).

107. *Krevolin v. Dimmick*, 467 A.2d 948, 953 (Conn. Super. Ct. 1983); *see also* *Foti v. United Serv. Auto. Ass'n*, No. FSTCV116010120, 2014 WL 3906863, at *12 (Conn. Super. Ct. July 2, 2014) (holding that "[h]aving not fulfilled its initial duty to defend, at least with a reservation of rights to contest coverage, USAA's arguments regarding the scope of coverage offered to Thorson are no longer at issue.").

108. *Capstone Bldg. Corp. v. Am. Motorists Ins. Co.*, 67 A.3d 961, 998 (Conn. 2013).

109. *See id.* at 999 (stating that "[a]lthough the insurer is estopped from contesting liability subsequent to a wrongful denial of a request for defense, the insured bears the burden of proving the reasonable allocation of the settlement in relation to the claims for which, when considered independently, the insurer had a duty to defend").

110. *Id.*

Similarly, in *Sauer v. Home Indemnity Co.*,¹¹¹ the Supreme Court of Alaska held that an insurer that breached its duty to defend a mobile home park owner against an action by park residents could not contest coverage in a suit by the insured to collect the judgment entered in the residents' action. Citing *Sims* and subsequent estoppel decisions, Alaska's highest court held that "an insurance company which wrongfully refuses to defend is liable for the judgment which ensues even though the facts may ultimately demonstrate that no indemnity is due."¹¹²

In *Farmers Union Mutual Insurance Co. v. Staples*,¹¹³ Montana's Supreme Court likewise held that because an insurer "unjustifiably refused to defend," it was "estopped from denying coverage."¹¹⁴ The insurer refused to defend based on evidence outside the complaint even though the complaint's allegations triggered its defense obligation. The insurer was held liable for judgments the insured confessed under Montana's rule that "where the insurer refuses to defend a claim and does so unjustifiably, that insurer becomes liable for defense costs and judgments."¹¹⁵

The Supreme Court of Rhode Island issued a decision in line with Illinois' estoppel rule, though without citing any cases from Illinois or other jurisdictions that recognize estoppel. In *Conanicut*

111. *Sauer v. Home Indem. Co.*, 841 P.2d 176 (Alaska 1992).

112. *Id.* at 184; *see also* *Lloyd's & Inst. of London Underwriting Cos. v. Fulton*, 2 P.3d 1199, 1209 (Alaska 2000) (holding that "an insurer's breach of the duty to defend must be considered a material breach that estops denial of coverage unless the breach clearly has no adverse impact on the relationship between the insurer and the insured"); *see also* *Fulton v. Lloyds & Inst. of London Underwriting Cos.*, 903 P.2d 1062, 1066 n.3 (Alaska 1995) (prescribing that "[t]he trial court's determination concerning the navigational warranty will be dispositive unless on remand the court finds that there was a material breach in connection with the defense duties owed the insured which gives rise to an estoppel to rely on policy and coverage defenses").

113. *Farmers Union Mut. Ins. Co. v. Staples*, 90 P.3d 381 (Mont. 2004).

114. *Id.* at 387 ("Having correctly determined that [insurer] FUMIC had a duty to defend, the [trial] court should have ended the analysis and concluded that since FUMIC breached that duty, it was estopped from denying coverage . . .").

115. *Id.* at 386 (quoting *Lee v. USAA Cas. Ins. Co.*, 86 P.3d 562, 565 (Mont. 2004)); *see also* *Dowson v. Scottsdale Ins. Co.*, 645 F. App'x 532, 533 (9th Cir. 2016) (providing "because Scottsdale breached its duty to defend Dowson and Montana Pride, it is liable for 100% of the defense and settlement costs incurred in the third-party lawsuit."); *see also* *Pacific Hide & Fur Depot v. Great Am. Ins. Co.*, 23 F. Supp. 3d 1208, 1213 (D. Mont. 2014) (stating that "[w]hen an insurer unjustifiably breaches its duty to defend, the insurer becomes liable for defense costs and judgments."); *see also* *Tidyman's Mgmt. Servs. Inc. v. Davis*, 330 P.3d 1139, 1149-50 (Mont. 2014) (stating that "Montana case law clearly provides that where the insurer refuses to defend a claim and does so unjustifiably, that insurer becomes liable for defense costs and judgments. . . . Rather, an insurer who breaches the duty to defend is liable for the full amount of the judgment, including amounts in excess of policy limits.") (quoting *Farmers Union Mut. Ins. Co. v. Staples*, 90 P.3d 381, 385 (Mont. 2004)) (quoting *Lee v. USAA Cas. Ins. Co.*, 86 P.3d 562, 565 (Mont. 2004)), later opinion at 378 P.3d 1182, 1183 (Mont. 2016) ("In *Tidyman's I*, we affirmed the District Court's finding that NUFI unjustifiably refused to defend its insured . . . and was therefore estopped from denying coverage.").

Marine Services, Inc. v. Insurance Co. of North America,¹¹⁶ the Rhode Island court was “not persuaded” by the insurer’s argument that “where an insurer in good faith refuses to defend an insured the insurer will not be required to pay settlement or damages awarded against the insured until the issue of coverage has been determined.” The court concluded:

We hold that where an insurer refuses to defend an insured pursuant to a general-liability policy, the insurer will be obligated to pay, in addition to the costs of defense and attorneys’ fees, the award of damages or settlement assessed against the insured. We note that [the insurer] defendant could have exercised one of two options instead of completely refusing to defend plaintiff. It could have entered into a nonwaiver agreement with plaintiff whereby it agreed to defend plaintiff and plaintiff recognized the right of defendant to question coverage, or defendant could have brought an action against plaintiff for a declaratory judgment on the question of coverage. In failing to reserve its right to contest coverage, defendant assumed the risk of being found in breach of its duty to defend at a subsequent time.¹¹⁷

The Wisconsin Supreme Court similarly held that “[i]nsurers are not allowed to contest coverage *after* a court has determined that the insurer has breached the duty to defend its insured because, having breached a contractual obligation, the insurer must pay damages flowing from that breach.”¹¹⁸ It also ruled:

While these damage awards are sometimes framed as the insurer being ‘estopped’ from denying coverage . . . they are the measure of damages actually caused by an insurer’s breach of the contractual

116. *Conanicut Marine Servs., Inc. v. Ins. Co. of N. Am.*, 511 A.2d 967, 970 (R.I. 1986).

117. *Id.* at 971, including n.10 (footnote included in text) (citation omitted). *Cf.* *Emhart Indus. v. Home Ins. Co.*, 515 F. Supp. 2d 228, 262 (D.R.I. 2007), *aff’d*, 559 F.3d 57 (1st Cir. 2009) (in which a federal district court reviewing subsequent Rhode Island decisions concluded that they “strongly suggest that *Conanicut* has lost its persuasive force”). *See also* *Furey Roofing & Constr. Co. v. Emp’rs Mut. Cas. Co.*, No. KC-2009-0685, 2010 WL 422253, at *8 (Super. Ct. R.I. Feb. 1, 2010) (in which a Rhode Island trial court also “decline[d] to interpret *Conanicut* as estopping an insurer from denying indemnity” because “*Conanicut* is not the majority rule, but is consistent with a minority of jurisdictions which estop an insurer that breaches its duty to defend from raising defenses to coverage” and several times since *Conanicut* the Rhode Island Supreme Court held that estoppel could not be invoked to expand policy coverage without referencing *Conanicut*); *but see* *Race City Fasteners, Inc. v. Selective Ins. Co.*, No. 5:05-CV-9-V, 2007 WL 1340404, at *7 (W.D.N.C. May 3, 2007) (concluding that “[b]oth Rhode Island and North Carolina law hold that when an insurer breaches its duty to defend, it waives its right to rely on any coverage defense and is then liable for the full amount of any judgment or settlement against its insured in the action it refused to defend.”); *see also* *Nationwide Ins. Co. v. Liberty Mut. Ins. Co.*, No. 2013 CH 19140, 2015 WL 12765439, at *15 (Cir. Ct. Ill. July 16, 2015) (finding “no substantive difference between the estoppel rules applied by Illinois and Rhode Island.”).

118. *Marks v. Houston Cas. Co.*, 881 N.W.2d 309, 332 (Wis. 2016).

duty to defend, not an estoppel based on some otherwise inequitable conduct in the eyes of the insured.¹¹⁹

Intermediate appellate courts in other states have embraced Illinois' estoppel rule, too.¹²⁰ In *Ames v. Continental Casualty Co.*, North Carolina's Court of Appeals held that under its state's law:

When an insurer, without justification refuses to defend its insured, the insurer is estopped from denying coverage and is obligated to pay the amount of any reasonable settlement made in good faith by the insured of the action brought against him by the injured party.¹²¹

This holding cited to a Seventh Circuit opinion that followed *Sims*,¹²² as well as the court's interpretation of a North Carolina Supreme Court opinion that held that an insurer's unjustified refusal to defend permits an insured to make "a reasonable compromise or settlement or consent judgment in good faith," requiring the insurer "to pay the amount and costs of such reasonable consent judgment"¹²³

The Indiana Court of Appeals cited the Illinois Supreme Court's *Ehlco* estoppel decision in noting:

If an insurer fails to defend under a reservation of rights or seek a declaratory judgment that there is no coverage and is later found to

119. *Maxwell v. Hartford Union High Sch. Dist.* 814 N.W.2d 484, 496 (Wis. 2012) (citation omitted).

120. *See, e.g., Price*, 684 P.2d at 531 (stating that "[w]hen an insurance company unjustifiably fails to defend it becomes liable for a judgment entered against the insured and for any settlement entered into by the insured in good faith. The settlement must be reasonable.") (citations omitted), *disapproved on other grounds*, *Ellingwood v. N.N. Investors Life Ins. Co.*, 805 P.2d 70 (N.M. 1991).

121. *Ames v. Cont'l Cas. Co.*, 340 S.E.2d 479, 485 (N.C. App. Ct. 1986).

122. *Maneikis v. St. Paul Ins. Co.*, 655 F.2d 818 (7th Cir. 1981) (applying Illinois law).

123. *Nixon v. Liberty Mut. Ins. Co.*, 120 S.E.2d 430, 436 (N.C. 1961); *see also Abrams & Abrams, P.A. v. Nat'l Union Fire Ins. Co.*, 605 F.3d 238, 241 (4th Cir. 2010) (holding "under North Carolina law, if an insurer improperly refuses to defend a claim, it is estopped from denying coverage and must pay any reasonable settlement – even if it made an honest mistake in its denial."); *see also Westfield Ins. Co. v. Nautilus Ins. Co.*, 154 F. Supp. 3d 259, 264 (M.D.N.C. 2016) (holding that "[a]n insurer that unjustifiably refuses to provide a defense to its insured faces severe consequences; it is liable for the amount and costs of a reasonable settlement entered into by the insured."); *see also Penske Truck Leasing Co., Ltd. P'ship v. Republic W. Ins. Co.*, 407 F. Supp. 2d 741, 753 (E.D.N.C. 2006) (stating that "North Carolina cases consistently hold that '[w]hen an insurer without justification refuses to defend its insured, the insurer is estopped from denying coverage and is obligated to pay the amount of any reasonable settlement made in good faith by the insured of the action brought against him by the injured party.'" (quoting *Ames*, 340 S.E.2d at 485); *see also Pulte Home Corp. v. Am. So. Ins. Co.*, 647 S.E.2d 614, 615-16 (N.C. App. Ct. 2007) (stating "This appeal is resolved by the principle, well-established in North Carolina, that an insurer who unjustifiably refuses to provide an insured with a defense is liable for the amount and costs of a reasonable settlement entered into by the insured. . . . American Southern unjustifiably refused to defend Pulte and is now liable for the settlement and Pulte's defense costs. Accordingly, we reverse and remand for entry of judgment in Pulte's and TransAmerica's favor.").

have wrongfully denied coverage, the insurer may be estopped from raising policy defenses to coverage. This estoppel doctrine has roots in the principle of equitable estoppel but “arose out of the recognition that an insurer’s duty to defend under a liability insurance policy is so fundamental an obligation that a breach of that duty constitutes a repudiation of the contract.”¹²⁴

Elements of estoppel appear in federal decisions applying the law of Indiana and various other states as well.¹²⁵ In what might be

124. *Emp’rs Ins. of Wausau v. Recticel Foam Corp.*, 716 N.E.2d 1015, 1028 n.16 (Ind. App. Ct. 1999)(citation omitted)(quoting *Ehlco*, 708 N.E.2d at 1135); *but see Thomson Inc. v. Ins. Co. of N. Am.*, 11 N.E.3d 982, 994 n.7 (Ind. App. Ct. 2014) (rejecting reliance on *Recticel* to hold insurer estopped without a finding that insurer had “*wrongfully denied coverage*” and in light of a subsequent Indiana Supreme Court decision that said “an insurer may choose at its own peril not to defend or seek a declaratory judgment, and failure to do either is not a waiver of defenses”) (quoting *Tri–Ech, Inc. v. Cincinnati Ins. Co.*, 909 N.E.2d 997, 1001 n.2 (Ind. 2009)).

125. *See Fed. Ins. Co. v. Stroh Brewing Co.*, 127 F.3d 563, 571 (7th Cir. 1997) (applying Indiana law and holding that insurer that waited six months to advise insured of its wrongful refusal to settle was barred from denying coverage based on a policy exclusion), *opinion on remand*, 35 F. Supp. 2d 650 (N.D. Ind. 1998) (estoppel for breach of duty to defend barred insurer from reliance on policy conditions as well as exclusions); *see also Jones v. S. Marine & Aviation Underwriters, Inc.*, 888 F.2d 358, 362 (5th Cir. 1989) (applying Mississippi law and concluding that “[t]hese cases indicate that unjustifiably denying liability or breaching a duty to defend will preclude an insurer from relying on policy provisions that deny coverage.”); *see also Columbus Life Ins. Co. v. Arch Ins. Co.*, No. 3:14–CV–01659, 2016 WL 2865952, at *12 (N.D. Ind. May 17, 2016) (predicting that “Ohio courts would hold that an insurer is estopped from denying coverage where it wrongfully disclaims coverage and refuses to defend or participate in the settlement of an action brought against an insured”); *see also State Farm Fire & Cas. Co. v. Ruiz*, 36 F. Supp. 2d 1308, 1318 (D.N.M. 1999) (applying New Mexico law and stating that “because State Farm unjustifiably refused to defend its insured, . . . State Farm may no longer raise any coverage defenses and is liable for the amount of the settlement, at least to policy limits, to the extent that the settlement was reasonable and entered into in good faith.”); *see also Galen Health Care, Inc. v. Am. Cas. Co.*, 913 F. Supp. 1525, 1533 (M.D. Fla. 1996) (applying Florida law) (holding that “[i]f the primary carrier refuses to defend it is estopped from later raising policy exclusions or defenses in subsequent actions.”); *see also Grindheim v. Safeco Ins. Co.*, 908 F. Supp. 794, 798 (D. Mont. 1995) (applying Montana law) (holding “an insurer who refuses, without justification, to defend its insured, will be estopped from denying coverage.”); *see also Gahagen Iron & Metal Co. v. Transp. Ins. Co.*, No. 91-F-1984, 1992 U.S. Dist. LEXIS 20817, at *17 (D. Colo. Nov. 9, 1992) (applying Colorado law and relating that “when an insurer breaches its duty to defend, . . . the insured need not proceed to trial, but may settle the underlying dispute. The insured may recover the amount of the settlement from the insurer if the facts then available to the insured established possible liability and the resulting settlement amount was reasonable in light of the ultimate potential liability and the likelihood of the underlying plaintiff’s success against the insured.”) (citation omitted). There are also contrasting cases from federal courts applying the law of several of these states. *See, e.g., Spencer v. Assurance Co. of Am.*, 39 F.3d 1146, 1149 (11th Cir. 1994) (holding that “Florida law clearly states that liability of an insurer depends upon whether the insured’s claim is within the coverage of the policy. This remains true even when the insurer has unjustifiably failed to defend its insured in the underlying action.”); *see also Flannery v. Allstate Ins. Co.*, 49 F. Supp. 2d 1223, 1229 (D. Colo. 1999) (stating that “an insurer is not precluded from contesting coverage when it has breached its obligation to

viewed as a variation of the rule, Washington courts have held insurers are estopped to dispute coverage if their breach of the duty to defend was in bad faith.¹²⁶ Washington courts describe this bad faith as a refusal that is “unreasonable, frivolous, or unfounded” as opposed to one “based on a reasonable interpretation of the policy.”¹²⁷ An Illinois court concluded that the Minnesota Supreme Court would also adopt Illinois’ estoppel rule if the issue came before it.¹²⁸

Courts and commentators analyzing California law have viewed it as incorporating at least some aspects of the Illinois estoppel rule. In *Gray v. Zurich Insurance Co.*,¹²⁹ the California Supreme Court held there is a “general rule that an insurer that wrongfully refuses to defend is liable on the judgment against the insured.” Later, in *Hogan v. Midland National Insurance Co.*,¹³⁰ the same court held that rule would not apply where it was clear the underlying judgment was based on a theory falling outside of coverage.¹³¹ In *Sentinel*, the Hawaii Supreme Court decided that these holdings placed California outside of Illinois’ estoppel rule.¹³²

defend its insured”).

126. *See* *Truck Ins. Exch. v. VanPort Homes Inc.*, 58 P.3d 276, 281 (Wash. 2002) (holding that “[i]t is unnecessary for us to reach the issue of whether or not coverage was excluded under specific policy provisions because we hold that an insurer that refuses or fails to defend in bad faith is estopped from denying coverage.”).

127. *Id.* at 290 (Bridge, J., dissenting) (quoting *Kirk v. Mt. Airy Ins. Co.*, 951 P.2d 1124, 1126 (Wash. 1998); *Transcon. Ins. Co. v. Wash. Pub. Utils. Dist. Util. Sys.*, 760 P.2d 337, 347 (Wash. 1988)); *see also* *Woo v. Fireman’s Fund Ins. Co.*, 208 P.3d 557, 564 (Wash. Ct. App. 2009) (holding that “[i]n order to establish bad faith, an insured is required to show the breach was unreasonable, frivolous, or unfounded.”).

128. *Eclipse Mfg. Co. v. U.S. Compliance Co.*, 886 N.E.2d 349, 352 (Ill. App. Ct. 2007) (“We affirm the judgment, holding that (1) the Illinois law of estoppel applies to this case because the laws of Minnesota and Illinois do not conflict . . .”). A federal district court, on the other hand, has concluded that Minnesota would reject the Illinois rule on the ground that estoppel can expand or create insurance coverage only where the insurer assumed the “defense and controlled the litigation of a claim.” *See* *PJ & RR Venture Cap, LLC v. Am. States Ins. Co.*, Civ. No. 10-5014 (RHK/LIB), 2011 WL 3678390, at *4 (D. Minn. July 7, 2011) (stating that “[s]imply put, if American can show that the underlying claims against Lopez were in fact not covered under its Policy, it cannot be estopped from denying coverage (and thus forced to expand coverage beyond its Policy) simply because it did not defend Lopez.”).

129. *Gray v. Zurich Ins. Co.*, 419 P.2d 168, 179 (Cal. 1966).

130. *Hogan v. Midland Nat’l Ins. Co.*, 476 P.2d 825 (Cal. 1970).

131. *See also* *DeWitt v. Monterey Ins. Co.*, 138 Cal. Rptr. 3d 705, 715 (Cal. Ct. App. 2012) (providing that “an insurer who breaches the duty to defend may contest coverage in a subsequent action ‘where the issues upon which coverage depends are not raised or necessarily adjudicated in the underlying action.’ Where coverage was not necessarily adjudicated in the underlying action, ‘the insurer is free to litigate those issues in [a] subsequent action and present any defenses not inconsistent with the judgment against its insured.’”) (citation omitted) (quoting *Pruyn v. Agric. Ins. Co.*, 42 Cal. Rptr. 2d 295, 302 n.15 (Cal. Ct. App. 1995)).

132. *Sentinel*, 875 P.2d at 910-11; *see also* *In Re C.M. Meiers Co.*, 527 B.R. 388, 407 (Bankr. C.D. Cal. 2015) (holding that “[f]ollowing the insurer’s refusal to defend, the insurer may litigate in a subsequent action against it by the insured whether the policy covered the liability underlying the settlement in the subsequent action, and

Other sources have reached a contrary conclusion.¹³³ According to one treatise: “The issue of the measure of damages for breach of the duty to defend remains unsettled in California.”¹³⁴

In light of the number of courts applying some form of the estoppel rule, one legal encyclopedia has stated:

Except where the insurance company would have faced a conflict of interest if it had defended the insured, the prevalent rule appears to be that once an insurance company violates its duty to defend, it is estopped to deny policy coverage in a lawsuit by the insured or the insured’s assignee, and is obligated to pay the amount of any damages awarded in that action, or any reasonable settlement made in good faith by the insured with the injured party, as well the insured’s attorney’s fees.¹³⁵

Even the commentator who said that only a “handful of cases” have held in favor of the rule cited cases applying the law of fifteen states to illustrate it.¹³⁶ Another scholar has noted that many states have not yet taken a firm position on the rule.¹³⁷ His analysis of those that did identified nineteen states that have definitively held against the rule with eleven espousing it, a far cry from the overwhelming rejection critics of the rule have posited.¹³⁸

damages paid pursuant to a settlement are recoverable if the insurance policy covered such damages.”); *see also* *Nvidia Corp. v. Fed. Ins. Co.*, No. 04 C 7178, 2005 WL 2230190, at *4, 14 (N.D. Ill. Sept. 6, 2005) (maintaining that “substantial authority in this area within California jurisprudence . . . reflects a substantially different approach to the issue than the one taken by Illinois law.” Under California precedent, “the measure of damages for a wrongful failure to defend [is] limited to the costs and attorney fees expended by the insured in defending the underlying action.”) (quoting *Everett Assocs., Inc. v. Transcon. Ins. Co.*, 159 F. Supp. 2d 1196, 1209 (N.D. Cal. 2001)) (quoting *Pruyn*, 42 Cal. Rptr. 2d at 302 n.15).

133. Neumeier, *supra* note 3, at 20 including n.22 (listing California among the states that “foreclose an insurer who wrongfully fails to defend from being able to avoid paying indemnity dollars by reason of the policy exclusion.”); *see also* Weiss, *supra* note 4, at 154 (stating that “the *Sims* holding . . . has spread plague-like from state to state. The estoppel rule has been adopted by several jurisdictions, most notably California . . .”) (footnote omitted); *see also* *Soc. of Mt. Carmel v. Nat’l Ben Franklin Ins. Co.*, 643 N.E.2d 1280, 1292 (Ill. App. Ct. 1994) (stating that “California law and Illinois law are in full accord” with respect to the estoppel rule).

134. *See* JOHN K. DIMUGNO & PAUL E.B. GLAD, CALIFORNIA INSURANCE LAW HANDBOOK § 46:34 (Apr. 2016 update) (stating that “[L]iability will be imposed on an insurer as a matter of law for a settlement or judgment not because its failure to defend proximately caused the settlement or judgment, but because the insurer is estopped to contest its duty to indemnify. The sticking point is determining what circumstances, if any, justify precluding an insurer from contesting coverage.”).

135. 46 C.J.S. *Insurance* § 1648 (Aug. 2016 update) (footnotes omitted).

136. Windt, *supra* note 1, at § 4:37, n.3.

137. Jeffrey W. Stempel, *Enhancing the Socially Instrumental Role of Insurance: The Opportunity and Challenge Presented by the ALI Restatement Position on Breach of the Duty to Defend*, 5 U.C. IRVINE L. REV. 587, 595 (2015).

138. *Id.* at 595 n.29.

B. *The Estoppel Rule Protects the Duty to Defend Better Than Bad Faith*

It is widely acknowledged, including by critics of the estoppel rule, that some type of recovery beyond the insured's defense costs should be possible in breach of duty to defend actions to deter insurers from shirking their defense obligations.¹³⁹ The need for such an enforcement device is readily apparent, as the insurer would otherwise risk no more than having to pay the costs it would have incurred had it assumed the defense anyway.¹⁴⁰ Critics of estoppel often suggest the potential for bad faith claims as a better deterrent.¹⁴¹ States permitting such actions typically find bad faith proven if a refusal to defend was "unreasonable, frivolous, or unfounded."¹⁴² Many such states will impose punitive damages on insurers.¹⁴³ "When courts allow punitive damages stemming from

139. See Windt, *supra* note 1, at § 4:37 (stating that "[i]f an insurer wrongfully refuses to defend an insured, it should be liable for the damages that the insured thereby incurs, and if the refusal to defend is egregious, the insurer should be liable for the insured's attorneys' fees and possibly punitive damages.).

140. See Weiss, *supra* note 4, at 148 (stating that in states refusing estoppel, an insurer weighing the consequences of a wrong decision on the duty to defend would find it "more advantageous to err on the side of denying coverage outright, given the chance that either the insured will not contest the decision, or the court will side with the insurer in the coverage declaratory judgment action if a case is brought. At worst, the insurer will have to pay only for the coverage denied, with perhaps some minor additional costs, like the insured's attorney fees, plus interest."); see also, Nardoni & Vishneski, *supra* note 3, at 233 (recommending the Illinois estoppel rule because it "changes th[e] calculation" for an insurer so that it cannot safely deny liability and then even if the insured sues and wins, simply face "liability . . . for only the defense costs it would have had to bear if it had assumed the defense").

141. See Windt, *supra* note 1, at § 4:37 (decrying estoppel but maintaining that if a "refusal to defend is egregious, the insurer should be liable for the insured's attorneys' fees and possibly punitive damages"); see also Chris Wood, *Assignments of Rights and Covenants not to Execute in Insurance Litigation*, 75 TEX. L. REV. 1373, 1405 (1997) (stating that "[t]he most cogent argument in favor of estopping the carrier from raising coverage defenses is that it is a deterrent to wrongful behavior. But this argument also seems unpersuasive. As described above, the carrier already is deterred because of the possibility of consequential or even punitive damages.") (footnote omitted); see also Weiss, *supra* note 4, at 166 (advocating that estoppel be restricted to "situations in which the insurer acts in bad faith in failing to defend.").

142. See STEVEN PLITT ET AL., COUCH ON INSURANCE 3D § 205:15 (updated 2016) (footnotes omitted) (stating that "[i]n essence, the test for whether there has been a bad-faith refusal to defend is whether a reasonable insurer would have denied or delayed payment of the claim under the facts and circumstances."). See, e.g., *Campbell v. Sup. Ct.*, 52 Cal. Rptr. 2d 385, 392-93 (Cal. Ct. App. 1996) (stating that "if an insurer unreasonably fails to defend, it has breached the implied covenant of good faith and fair dealing."); see also *Smith v. Am. Family Mut. Ins. Co.*, 294 N.W.2d 751, 759 (N.D. 1980) (recognizing cause of action for bad faith breach of the duty to defend).

143. Couch, *supra* note 142, at § 205:90; see also *Woodliff v. Cal. Ins. Guar. Ass'n*, 3 Cal. Rptr. 3d 1, 13 n.15 (Cal. Ct. App. 2003) (providing "an insurer's refusal to defend can also create tort liability on the theory that an unreasonable failure to defend is a breach of the implied covenant of good faith and fair dealing. On this

the breach of an insurance contract, the insured generally must prove tortious conduct by the insurer, such as willful or wanton conduct, malice, or intent to injure.”¹⁴⁴

Although talking about bad faith sounds threatening, the potential for bad faith actions should not displace the estoppel rule. Bad faith claims are not available everywhere, and the Illinois estoppel rule is a superior enforcement device for the duty to defend in any event.

1. *Only Some States Offer Viable Bad Faith Claims*

Not all states permit bad faith claims for breaching a duty to defend.¹⁴⁵ “In a number of states, common law ‘bad faith’ cannot constitute a cause of action against one’s third-party liability insurance carrier.”¹⁴⁶

Illinois is a prime example. It does not recognize an insurer’s bad faith failure to perform its policy obligations as a tort.¹⁴⁷ Instead, it has a statute that empowers courts to award attorney fees and a limited statutory penalty as taxable costs where an

latter theory, the insurer could be liable for tort damages not embraced in the breach of contract action such as compensation for emotional distress and punitive damages.”).

144. Bowdre, *supra* note 12, at 777.

145. See STEPHEN S. ASHLEY, *BAD FAITH ACTIONS LIABILITY & DAMAGES* § 4:10 (2d ed. 2016 update) (noting “[t]he courts disagree on whether a breach of the express promise to defend supports a cause of action based on the implied promise to deal fairly and in good faith.”).

146. See Edward Zampino & M. Jarett Coleman, *Turning the Other Cheek: Can Insurers’ Defense of Coverage Suits Constitute Grounds for Bad Faith Litigation?*, 38 *TORT TRIAL & INS. PRAC. L.J.* 103, 106 (2002) (claiming that “[i]n such states, no form of bad faith claim, including one based on an insurer’s alleged bad faith ‘litigation’ conduct, is sustainable in the first instance when a third-party insurer is involved.”) (citing *Md. Ins. Co. v. Head Indus. Coatings & Ser., Inc.*, 938 S.W.2d 27, 29 (Tex. 1996), as “rejecting ‘bad faith’ cause of action for insurer’s breach of the duty to defend”); see also Couch, *supra* note 142, at § 205:15 (noting “[i]f it can be shown subsequently upon development of facts that a claim against insured is covered by a policy, the insurer necessarily is liable for breach of its covenant to defend. Alternatively, in those jurisdictions recognizing a cause of action for bad-faith breach of a duty to defend, a bad-faith refusal to defend may be asserted if the insured can make a showing that the insurer’s denial was unreasonable, frivolous, or unfounded.”) (footnotes omitted).

147. *Cramer*, 675 N.E.2d at 900-04; see also *Strategic Capital Bancorp, Inc. v. St. Paul Mercury*, No. 10–CV–2062, 2014 WL 562970, at *6 (C.D. Ill. Feb. 13, 2014) (stating that “Illinois law does not allow a policyholder to bring an independent tort claim for ‘bad faith or unreasonable and vexatious conduct’ by an insurer.”); see also *Carolina Cas. Ins. Co. v. Merge Healthcare Sols., Inc.*, Civ. No. 11 C 3844, 2012 WL 123987, at *7 (N.D. Ill. Jan. 13, 2012) (ruling that “Carolina Casualty argues it is entitled to summary judgment on the bad faith counterclaim because a common law action for bad faith does not exist in either Illinois or Massachusetts. Carolina Casualty is correct.”); see also *Woodard v. Am. Family Mut. Ins. Co.*, 950 F. Supp. 1382, 1393 (N.D. Ill. 1997) (observing that “there is no common law tort for bad faith or unreasonable and vexatious conduct.”).

insurer's failure to provide promised coverage was "vexatious and unreasonable."¹⁴⁸ The statute is not a strong deterrent, however, because claims under it fail if the insurer can voice anything approximating a reasonable dispute over its obligation.¹⁴⁹ This might even include arguments its counsel devises well after a defense was denied, as some cases refuse to hold insurers to the grounds they identified while disclaiming coverage.¹⁵⁰ As the Illinois Supreme Court has acknowledged, the estoppel rule is an essential enforcement device for the duty to defend in Illinois' circumstances.¹⁵¹

2. *Illinois' Estoppel Rule Has Several Advantages Over Bad Faith as An Enforcement Device*

The Illinois estoppel rule is superior to bad faith as deterrence to insurer breaches of their defense obligations. The estoppel rule is

148. Illinois Insurance Code, 215 ILCS § 5/155(1)(West 2012). The statutory remedy is, of course, in addition to the right to recover for unpaid defense costs for the underlying action against the insured. Also, as previously noted, Illinois courts hold in theory that an insurer that breached its duty to defend in bad faith can be held liable beyond its policy limits, but to the best of my research, no insurer has ever been held liable that way in a published Illinois decision. See text accompanying note 57 *supra*.

149. See *JAR Labs. LLC v. Great Am. Ins. Co.*, 945 F. Supp. 2d 937, 948-49 (N.D. Ill. 2013) (holding that "[w]hatever may have been the reason for defendant's flip-flopping on whether it would defend plaintiff," statutory sanctions were refused because the record established "a bona fide dispute concerning coverage."); see also *Auto-Owners Ins. Co. v. Yocum*, 987 N.E.2d 494, 502-03 (Ill. App. Ct. 2013) (stating that although insurer "never had any basis to cancel the policy," the trial court did not err in refusing statutory sanctions where it found "there was a bona fide dispute as to whether the policy was properly cancelled."); see also *Baxter Int'l, Inc. v. Am. Guarantee & Liab. Ins. Co.*, 861 N.E.2d 263, 272 (Ill. App. Ct. 2006) (observing that an insurer's failures "will not be deemed vexatious or unreasonable . . . where a bona fide dispute over coverage exists."); see also *Nardoni & Vishneski*, *supra* note 3, at 253 n. 43 (stating that Illinois' "statute alone . . . is an insufficient deterrent" without estoppel because "[c]ourts have been reluctant to hold carriers liable under the statute if they can assert some colorable argument for refusing coverage, even if that argument was weak and erroneous.").

150. See, e.g., *Tobi Eng'g, Inc. v. Nationwide Mut. Ins. Co.*, 574 N.E.2d 160, 162 (Ill. App. Ct. 1991) (holding that the insurer was not "restricted to its exclusionary defenses" asserted in its coverage denial letter; "an insurer is not required to assert all of its defenses to liability in a letter to its insured."). There is some Illinois authority, however, that holds an insurer cannot rely on defenses omitted from its disclaimer letter under the "mend the hold" doctrine. See *Indian Harbor Ins. Co. v. Lunn*, No. 06 C 3008, 2007 WL 1725300, at *5 (N.D. Ill. June 12, 2007) (ruling that "[b]ased on the representations in the letters, Indian Harbor denied coverage to Lunn and Lunn Partners on the sole basis that Lunn Partners did not provide Indian Harbor timely notice of the litigation and, as such, any arguments, statements, or allegations for its denial of coverage under the Policy for other reasons is improper.").

151. See *Ehlco*, 708 N.E.2d at 1136 (rejecting a late notice exception to the estoppel rule because "[t]o hold otherwise would seriously undermine the effectiveness of the estoppel doctrine and its intended enforcement of the duty to defend.").

better because it promotes a quick judicial determination of the duty to defend and provides clear guidelines for all concerned parties.

a. The Rule Promotes a Prompt Judicial Determination

At its core, the Illinois estoppel rule is a rule “of timeliness for insurers.”¹⁵² It recognizes that when a policyholder has been sued, it needs prompt insurer action. The rule promotes prompt action by requiring insurers to either assume the insured’s defense under a reservation of rights or seek court guidance as to their obligations.¹⁵³ Only an insurer that neither defends nor seeks declaratory relief is deemed to have breached its duty to defend and thereby estopped from disputing coverage for a judgment or settlement that resolves the case it should have defended.¹⁵⁴ A prompt declaratory action will enable a court to determine whether a defense is owed at an early stage, preventing a breach of the defense obligation. This furthers the public policy of ensuring the policyholder is effectively defended and that the underlying suit reaches a fair result.¹⁵⁵

A bad faith cause of action, on the other hand, contemplates a suit to be brought later. Rather than require the insurer to either defend or seek court guidance on whether it owes a defense, the bad faith approach places the burden on the policyholder to pursue the insurer. Resolving the case will involve more than simply deciding whether a duty to defend arose but whether the insurer’s failure to defend was in bad faith, something that will not be found if the duty to defend was unclear.¹⁵⁶ It would have been simpler and less

152. Nardoni & Vishneski, *supra* note 3, at 246.

153. *See Martin*, 710 N.E.2d at 1232 (holding “when a complaint against the insured alleges facts potentially within the scope of the policy coverage, an insurer taking the position that the complaint is not covered by its policy must defend the suit under a reservation of rights or seek a declaratory judgment. An insurer will not be estopped from denying coverage merely because the underlying case proceeds to judgment before the declaratory judgment action is resolved.”).

154. *Id.*

155. *See Cincinnati Cos. v. W. Am. Ins. Co.*, 701 N.E.2d 499, 505 (Ill. 1998) (noting that “the state has an interest in having an insured adequately represented in the underlying litigation.”).

156. *See, e.g., Dewitt Constr. Inc. v. Charter Oak Fire Ins. Co.*, 307 F.3d 1127, 1138 (9th Cir. 2002) (deciding that a bad faith claim was properly dismissed because “Travelers’s duty to defend was not unambiguous” and “coverage was unclear”); *see also MCE Automotive, Inc. v. Nat’l Cas. Co.*, C/A No. 6:11–1245–TMC, 2012 WL 4479163, at *6 (D.S.C. Sept. 28, 2012) (holding that “[u]nder South Carolina law, an insurer acts in bad faith when there is no reasonable basis to support the insurer’s decision.”), *aff’d*, 535 F. App’x 303 (4th Cir. 2013); *see also U.S. v. CNA Fin. Corp.*, 168 F. Supp. 2d 1109, 1122 (D. Alaska 2001) (stating that “[t]o establish a claim for bad faith denial of coverage, a plaintiff must show that the defendant-insurer lacked a reasonable basis for denying benefits of the policy and that the defendant-insurer had knowledge that no reasonable basis existed to deny the claim or acted in reckless disregard for the lack of a reasonable basis for denying the claim.”), *adopted*, 168 F. Supp. 2d 1125 (D. Alaska 2001); *see also Home Indem. Co. v. Godley*, 177 S.E.2d 105,

burdensome for the parties and the court if the insurer had instead sought court guidance at an early stage as Illinois' estoppel rule dictates.

The estoppel rule is also superior because it requires the insurer to act when its duty is unclear. Under Illinois' estoppel rule, an insurer can feel secure in refusing to act entirely only where it is certain no defense is owed. If there is any possibility it owes a defense, it should at least ask court guidance. If bad faith is the only deterrent, however, the insurer may feel safe in refusing to defend as long as it will be able to offer some reasonable basis for disputing its obligation. By requiring insurers to act in the face of uncertainty, Illinois' rule offers a stronger method to ensure that policyholders are not left unprotected.

b. *The Rule Provides Clear Guidance for All Parties*

The Illinois estoppel rule is also a better enforcement device because it provides clarity as to the parties' responsibilities. Insurers know the consequences of both refusing to defend and failing to seek declaratory relief. The rule does not subject the parties to a fact-specific trial on whether the insurer acted without the requisite good faith. Moreover, those recommending bad faith actions as a substitute for estoppel should bear in mind that bad faith actions have at times produced punitive damage verdicts considered astronomical.¹⁵⁷ Estoppel seems much less radical given the uncertainties of bad faith litigation. As one commentator observed:

The well-recognized purpose of punitive damages is to punish the defendant and deter similar conduct. In suits for wrongful refusal to defend, deterrence can be achieved by broadening the damages recoverable so the insured is fully compensated for the insurer's breach. If full recovery of foreseeable damages is allowed, the need for punitive damages as a deterrent to insurer misconduct should recede.¹⁵⁸

C. The Rule is not an Unwarranted Manipulation of Basic Contract Law

The estoppel rule arguably does expand general contract law. For example, under general law, one party's material breach of a contract will excuse the other contracting party's future failure to

111 (Ga. Ct. App. 1970) (asserting that "If there is any reasonable ground for contesting the claim there is no bad faith . . .").

157. See *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 429 (2003) (reducing \$145 million punitive damage judgment the Court judged to be "an irrational and arbitrary deprivation of the property of the" insurer).

158. Bowdre, *supra* note 12, at 780.

perform.¹⁵⁹ The material breach does not excuse past failures to perform.¹⁶⁰ The Illinois estoppel rule may be viewed as going beyond general contract law in that an insurer's failure to defend can effectively excuse the insured's prior failure to perform duties such as notifying the insurer of the suit reasonably promptly.¹⁶¹

It is unfair to criticize the Illinois estoppel rule on that basis alone, however, as insurance law is filled with expansions of general contract law principles due to the unique public policy concerns involved in the insurance relationship.¹⁶² One example is the rule of *contra proferentem*, which construes ambiguous contractual provisions against the party that drafted the agreement. Under general contract law, when a contractual provision has multiple reasonable meanings, the one that operates against its drafter "is generally preferred."¹⁶³ This doctrine is applied with special force, however, in the insurance context based on the view that insurance policies are typically contracts of adhesion.¹⁶⁴ Rather than merely

159. See, e.g., *Sterling Research, Inc. v. Pietrobono*, No. 02-40150-FDS, 2005 WL 3116758, at *9 (D. Mass. Nov. 21, 2005) (holding that "[i]t is axiomatic that one party's breach of a material term of an agreement excuses the other party from any future performance due under that agreement."); see also *Mustang Pipeline Co. v. Driver Pipeline Co.*, 134 S.W.3d 195, 196 (Tex. 2004) (relating that "[i]t is a fundamental principle of contract law that when one party to a contract commits a material breach of that contract, the other party is discharged or excused from further performance.").

160. *Simon v. FDIC*, 48 F.3d 53, 57 n.1 (1st Cir. 1995).

161. *Ehlco*, 708 N.E.2d at 1135-37.

162. See Jeffrey W. Stempel, *Interpretation of Insurance Contracts* 296 (1994), quoted in Robert H. Jerry II, *Consent, Contract, and the Responsibilities of Insurance Defense Counsel*, 4 CONN. INS. L.J. 153, 164 n.45 (1997) (recounting that "[t]he insurance policy remains a species of contract," but contract law has been "modified over the years in the insurance context" such that a "current hybrid of basic contract law infused with a number of largely pro-policyholder modifications continues to dominate policy coverage questions.").

163. See RESTATEMENT (SECOND) OF CONTRACTS § 206 (stating that "[i]n choosing among the reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds."); see also 5-24 *Corbin on Contracts* § 24.27 (2016) (providing "[i]f . . . it is clear that the parties did attempt to make a valid contract and the only remaining question is which of two possible and reasonable meanings should be adopted, the court will often adopt the meaning that is less favorable in its legal effect to the party who chose the words. This technique is known as 'contra proferentem.'").

164. See Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1607 (2005) (stating that the "doctrine is applied with particular vehemence to insurance contracts"); see also Catherine Spain, *Reasonable Expectations in the Sphere of Liberty: A Theory of Accidental Death Insurance Coverage*, 12 CONN. INS. L.J. 657, 677 (2006) (explaining that the doctrine is "[m]ore rigorously applied in insurance than in other contracts . . ."); see also Catherine A. Salton, *Mental Incapacity and Liability Insurance Exclusionary Clauses: The Effect of Insanity Upon Intent*, 78 CAL. L. REV. 1027, 1031 (1990) (stating that "[t]he . . . doctrine has been applied with particular force to insurance policies. As one court pointed out, insurance contracts are 'drawn for the company by men learned in the law of insurance'; it is unlikely that the hapless purchaser of the policy will be equally

preferring an interpretation that favors the non-drafting party, courts usually hold that all insurance policy ambiguities *must* be resolved against the insurer.¹⁶⁵

Bad faith actions are a similar judicial expansion of remedies peculiar to insurance law. Although all contracts are viewed as containing a covenant of good faith and fair dealing, a right of action for breach of the covenant is often confined to cases against insurers because of the unique aspects of the insurance relationship, particularly the dependent relationship of policy insureds.¹⁶⁶ As one commentator explained in defending this circumstance:

[A] breach by the insurer upon the filing of a third-party claim differs from the traditional commercial contract. In the textbook commercial setting, the breaching party may have received payment for goods that it chose not to deliver in accordance with the parties' contract, but the benefits of such a breach would be easily disgorged. In the insurance context, however, an insured has necessarily performed his or her end of the bargain by dutifully paying premiums, often for years. Upon being sued by a third party, the insured looks to its insurer for the rendering of an esoteric duty at a peculiarly precarious time for the insured. An insurer could not conceivably satisfy its duty to the insured with delivery of a check for legal services because the duty to defend transcends the mere capital outlay in hiring a lawyer and litigating a civil action. The California Supreme Court succinctly

educated.") (quoting *Ruvolo v. Am. Cas. Co.*, 189 A.2d 204, 208 (N.J. 1963)).

165. See, e.g., *Lexington Ins. Co. v. W. Pa. Hosp.*, 423 F.3d 318, 336 (3d Cir. 2005) (Fuentes, J., dissenting) (stating that "[i]f the insurance policy is ambiguous, we must construe it in favor of the insured . . ."); see also *Westport Ins. Corp. v. Tuskegee Newspapers, Inc.*, 402 F.3d 1161, 1163 (11th Cir. 2005) (relating that "under Alabama law, ambiguities in insurance policies must be construed in favor of the insured"); see also *Cohen v. N.Y. Prop. Ins. Underwriting Ass'n*, 410 N.Y.S.2d 597, 612 (App. Div. 1978) (Lupiano, J., dissenting) (observing that "the rule of strict construction mandates that the provisions of the standard policy 'be construed most strongly against the insurer, and liberally in favor of the insured.'") (quoting 29 N.Y. Jur. Insurance § 596); see also *Barnett v. Aetna Life Ins. Co.*, 723 S.W.2d 663, 666 (Tex. 1987) (stating that insurance "policies should be construed strictly against the insurer and liberally in favor of the insured," and "we must adopt the construction of an exclusionary clause urged by the insured as long as that construction is not itself unreasonable, even if the construction urged by the insurer appears to be more reasonable or a more accurate reflection of the parties intent.") (quoting *Glover v. Nat'l Ins. Underwriters*, 545 S.W.2d 755, 761 (Tex. 1977)).

166. See *Nome Commercial Co. v. Nat'l Bank of Alaska*, 948 P.2d 443, 452 (Alaska 1997) (recounting that "a claim for a breach of the implied covenant of good faith and fair dealing in ordinary commercial contracts sounds only in contract. Insurance contracts, because of the special relationship between the insurer and the insured, justify an action in tort for such a breach.") (citation omitted); see also *State Farm Mut. Auto. Ins. Co. v. Brekke*, 105 P.3d 177, 188 (Colo. 2004) (stating that "[u]nlike the breach of the implied duty of good faith and fair dealing in an ordinary contract, breach in an insurance contract gives rise to a separate cause of action in tort."); see also *Wathor v. Mut. Assur. Admin., Inc.*, 87 P.3d 559, 561 (Okla. 2004) (holding that "[e]very contract in Oklahoma contains an implied duty of good faith and fair dealing. In ordinary commercial contracts, a breach of that duty merely results in damages for breach of contract, not independent tort liability. Insurance contracts, however, are not ordinary commercial contracts.") (citations omitted).

stated this policy rationale: “The availability of tort remedies in the limited context of an insurer’s breach of the covenant [of good faith] advances the social policy of safeguarding an insured in an inferior bargaining position who contracts for calamity protection, not commercial advantage.”¹⁶⁷

Refusing the Illinois estoppel rule simply because it extends beyond ordinary contract law is not persuasive under this analysis. As previously noted, even critics of estoppel have no difficulty embracing bad faith claims as a substitute.

Moreover, as previously mentioned, the estoppel rule may be understood as setting forth an evidentiary presumption.¹⁶⁸ That is because apart from estoppel, general insurance law holds that an insurer that breaches its duty to defend can be held liable for a judgment or settlement as an element of consequential damages stemming from the breach. This would apply in circumstances in which the policyholder had to capitulate for the lack of ability to defend itself.¹⁶⁹ Cases applying the estoppel rule effectively presume that the resulting judgment or settlement was such a consequence. They presume that if the insurer had satisfied its duty to defend, it would have been successful in avoiding liability to the insured. This is done so as not to impose “upon the [insured] plaintiff the difficult burden of proving a causal relation between the [insurer] defendant’s breach of the duty to defend and the results which are claimed to have flowed from it.”¹⁷⁰ The rule prevents a breaching insurer from “cast[ing] upon the insured not only the unpleasant but the extremely difficult burden of proof on the issue whether the defendant’s attorneys, by superior skill and wisdom, could have produced a better result at less expense than that achieved by the plaintiff’s counsel.”¹⁷¹

167. Matthew D. Schultz, *Bad Faith or No Faith? Finding A Place for Wrongful Refusal to Defend in Florida’s Bad Faith Jurisprudence*, 29 FLA. ST. U. L. REV. 1389, 1423-24 (2002) (footnote omitted) (quoting *Kransco v. Am. Empire Surplus Lines Ins. Co.*, 2 P.3d 1, 8 (Cal. 2000)).

168. See text accompanying note 100 *supra*.

169. See Windt, *supra* note 1, at § 4:37. See, e.g., *Hamlin, Inc. v. Hartford Acc. & Indem. Co.*, 86 F.3d 93, 94-95 (7th Cir. 1996) (holding that the state whose law controlled would not hold “that an obligation to pay the entire settlement or judgment is the automatic consequence of a finding of a breach of the duty to defend,” but there could be liability if “the insured . . . show[s] that he was made worse off by the breach than he would have been had the breach not occurred. This is also the majority view.”) (citation omitted); see also *Amato v. Mercury Cas. Co.*, 61 Cal. Rptr. 2d 909, 911, 913-14 (Cal. App. Ct. 1997) (stating that “[w]here an insured mounts a defense at the insured’s own expense following the insurer’s refusal to defend, the usual contract damages are the costs of the defense.” But “where an insurer tortiously breaches the duty to defend and the insured suffers a default judgment because the insured is unable to defend, the insurer is liable for the default judgment, which is a proximate result of its wrongful refusal to defend.” “[T]he insurer is liable on the judgment and cannot rely on hindsight that a subsequent lawsuit establishes noncoverage.”).

170. *Missionaries*, 230 A.2d at 26.

171. *Id.*

Presumptions, including conclusive ones, are often applied both for and against policyholders in insurance cases. For example, courts have held that receipt of an insurance policy constitutes “conclusive presumptive knowledge” of the policy’s “terms and limits.”¹⁷² Some have also found a “conclusive presumption of prejudice” where an insurer assumes control of the insured’s defense without adequately informing the insured of a reservation of rights.¹⁷³ As to the latter presumption, courts have reasoned that “[a]nalyzing how a case might have gone differently for an insured if he had been aware of a reservation of rights is an inherently speculative undertaking,” and “one strong argument supporting a conclusive presumption of prejudice is the difficulty of proving prejudice, given the hypothetical nature of the undertaking.”¹⁷⁴

It may, of course, be debated whether a conclusive presumption is warranted where the insurer wrongfully refuses to defend. A critic of the estoppel rule maintains as a “fact” that “there is almost never” a causal relationship “between the insurer’s breach of contract and the subsequent judgment or settlement.”¹⁷⁵ The commentator does not offer authority confirming that statement, however.¹⁷⁶ Case law, on the other hand, reflects instances in which an insured could not mount an effective defense without the insurer participation.¹⁷⁷ As other commentators have noted, a policyholder deprived of an insurer’s defense necessarily suffers. One observed:

In the discharge of its Defense Duty, a carrier can take advantage of its experience in the defending of similar claims, its statistical analyses of claims data, and its special expertise arising from its background and special skills that provide the carrier with insight into the best defense approach. These advantages are accompanied by the insurer’s control of an apparatus that is suited for the defense

172. *Hess v. Baccarat*, 731 N.Y.S.2d 296, 299 (App. Div. 2001) (quoting *Madhvani v. Sheehan*, 650 N.Y.S.2d 490, 492 (App. Div. 1996); *Rogers v. Urbanke*, 599 N.Y.S.2d 697, 698 (App. Div. 1993)).

173. *Knox-Tenn Rental Co. v. Home Ins. Co.*, 2 F.3d 678, 684 (6th Cir. 1993); see also *Gay & Taylor, Inc. v. St. Paul Fire & Marine Ins. Co.*, 550 F. Supp. 710, 715 (W.D. Okla. 1981) (stating “[p]rejudice to an insured is conclusively presumed where an insurer assumes the defense of an action and denies liability on the eve of trial.”).

174. *Knox-Tenn Rental*, 2 F.3d at 685, including n.7.

175. *Windt*, *supra* note 1, at § 4:37.

176. *Id.* The author cites only another section of his own treatise for support. *Id.* n.7. The other section recites the author’s view, without any direct citation of authority, that “[i]n most” cases in which the insurer wrongfully refuses to defend, “there is no basis for concluding that a judgment would have been for a lesser amount had the defense been conducted by counsel provided by the insurer.” *Id.* at § 4:36.

177. See *Abrams*, 605 F.3d at 242 (stating that “[w]ithout National Union, McKiernan could not afford counsel and instead defended himself. . . . [T]he district court entered a \$75 million judgment against him”); see also *Crocker v. Nat’l Union Fire Ins. Co.*, No. SA-04-CA-0389-RF, 2005 WL 1168429, at *5 (W.D. Tex. May 12, 2005) (relating that “the former nursing home employee failed to appear at the trial because he could not afford counsel and did not know of National Union’s duty to defend him”).

of such claims and the carrier's financial ability to retain competent outside counsel to defend litigation against the insured.¹⁷⁸

Regardless of the debate over whether the presumption is justified, the presumption does not appear significantly different in nature from other accepted presumptions.

Additionally, the Illinois estoppel rule is essentially one of timeliness, barring disputes over coverage only when the insurer failed to seek declaratory relief at an early stage. Given the timeliness component, the rule has been viewed as a form of laches.¹⁷⁹ Laches, of course, is another established legal principle.¹⁸⁰

D. The Estoppel Rule is Fair to All Parties

Those decrying the estoppel rule as a windfall for policyholders overlook that as practiced in Illinois, the rule does not deprive insurers of any of their defenses to coverage as long as they test them on a timely basis. Insurers questioning coverage for a suit against their insureds may accept their insureds' defense under a reservation of rights or seek court instruction on their duties through a declaratory action. The declaratory option provides "a safe harbor for an insurer who learns its insured has been sued but is uncertain whether it must defend."¹⁸¹ The availability of the declaratory remedy prevents the type of windfall critics of the rule decry.¹⁸²

Critics charging unfairness also overlook that the estoppel rule provides a recovery device for insurers as well as policyholders. Illinois case law is replete with instances in which an insurer that met its obligations to an insured successfully asserted the estoppel rule against another insurer that failed to defend.¹⁸³ Such actions

178. Michael A. Haskel, *Case Law Developments Addressing the Consequences of a Liability Insurer's Breach of its Duty to Defend*, 36 PACE L. REV. 217, 231 (Fall 2015).

179. See Stempel, *supra* note 137, at 609 (observing that "A laches analysis also makes some sense in that the insurer that erroneously refused to defend has bypassed an opportunity to assert its rights (to defend under reservation and/or seek declaratory judgment).").

180. See *id.* at 609, n. 87 (explaining that "[l]aches is the legal concept that bars a party from asserting rights in litigation when it has failed prior to the litigation to act in a timely fashion regarding those rights").

181. See Nardoni & Vishneski, *supra* note 3, at 227.

182. See Haskel, *supra* note 178, at 241 (making the argument that the rule "is unfair because it results in 'automatic indemnity . . .' is badly flawed. Indemnity is not 'automatic,' because the carrier can bring a declaratory judgment action or defend under a reservation of rights."); see also Jerry & Richmond, *supra* note 2, at 826 (stating that "it is the availability of these procedural alternatives" allowing an insurer to "defend under a reservation of rights" and "file a separate declaratory judgment action" to decide coverage "that provides the best reason for estopping the insurer to deny coverage when it breaches the duty to defend.").

183. See *Mt. Hawley Ins. Co. v. Certain Underwriters at Lloyd's*, 19 N.E.3d 106, 107 (Ill. App. Ct. 2014) (affirming summary judgment that found Underwriters

are not only common; they have produced holdings that confirmed important aspects of the estoppel rule.¹⁸⁴ Insurers unsuccessfully claimed estoppel in many additional cases.¹⁸⁵ Case law

estopped because “it refused to defend its additional insureds” or “seek a declaratory judgment”); *see also* *Statewide Ins. Co. v. Houston Gen. Ins. Co.*, 920 N.E.2d 611, 623 (Ill. App. Ct. 2009) (deciding that subcontractor’s liability insurer sued by general contractor’s insurer was “estopped from asserting any policy defenses to coverage” because it “breached its duty to defend and indemnify”); *see also* *Ill. Emcasco Ins. Co. v. Nw. Nat’l. Cas. Co.*, 785 N.E.2d 905, 910 (Ill. App. Ct. 2003) (holding Northwestern “estopped” from raising policy defenses to coverage in suit by general contractor’s insurer); *see also* *RLI*, 781 N.E.2d at 333 (concluding that the “circuit court properly” agreed with RLI that “Illinois National . . . breached its duty to defend by not providing a defense under both of the policies and, therefore, was estopped from asserting any policy exclusions”); *see also* *Ins. Co. of Ill. v. Fed. Kemper Ins. Co.*, 683 N.E.2d 947, 949 (Ill. App. Ct. 1997) (deciding an “under/uninsured motorist” carrier successfully “alleged that, because Federal Kemper owed a defense and indemnity . . . and denied such a defense it is now estopped from asserting policy defenses to coverage”); *see also* *Ins. Co. of Pa.*, 592 N.E.2d at 123 (concluding that “the trial court properly granted summary judgment in favor of Protective and entered judgment against Pennsylvania based upon the equitable principle of estoppel.”); *see also* *Aetna*, 553 N.E.2d at 41-42 (deciding that auto liability insurer that refused to defend was estopped from arguing policy defenses to coverage in action by homeowners’ insurer); *see also* *Northbrook Prop. & Cas. Ins. Co. v. U.S. Fid. & Guar. Co.*, 501 N.E.2d 817, 818-21 (Ill. App. Ct. 1986) (holding that subcontractor’s insurer confronted with complaint that had allegations “within or potentially within the coverage” it afforded to general contractor Schal as an additional insured but “did not defend Schal under a reservation or rights or secure a declaratory judgment that it owed Schal no duty to provide it with a defense” was “estopped from asserting any defenses to coverage” in suit by Schal’s insurer, which “undertook the defense of Schal”); *see also* *Aetna Cas. & Sur. Co. v. Coronet Ins. Co.*, 358 N.E.2d 914, 916-17 (Ill. App. Ct. 1976) (holding insurer of auto owner that refused to defend suit against driver estopped to raise “exclusionary coverage defense” in suit by driver’s insurer, Aetna, which “did defend the suit on behalf of” the driver).

184. *See Ins. Co. of Pa.*, 592 N.E.2d at 123 (establishing that the existence of a conflict of interest prohibiting an insurer from defending will not protect it from estoppel where it fails to reimburse defense costs on an ongoing basis); *see also* *Coronet*, 358 N.E.2d at 918-18 (establishing that prejudice is not necessary for estoppel).

185. *Hartford Accident & Ins. Co. v. Gulf Ins. Co.*, 837 F. 2d 767, 770 (7th Cir. 1988)(deciding that although “Hartford moved for a declaration of estoppel against Gulf,” trial was needed on tender of defense); *see also* *Nationwide Agribusiness Ins. Co. v. Gen. Cas. Co. of Ill.*, 2016 IL App (1st) 151480-U, ¶¶ 44-49 (unpublished and non-precedential) (refusing claim “General Casualty should be estopped,” as it “offered to defend”); *see also* *Certain Underwriters at Lloyd’s, London v. Cent. Mut. Ins. Co.*, 12 N.E.3d 762, 765, 770 (Ill. App. Ct. 2014) (holding that an effort to hold CMIC “estopped from asserting policy defenses” failed where it lacked duty to defend); *see also* *Md. Cas. Ins. Co. v. United Nat’l. Ins. Co.*, No. 1–10–0454, 2011 WL 10069095, at *6 (Ill. App. Ct. Jan. 26, 2011) (unpublished and non-precedential) (rejecting estoppel for failure “to show Maryland breached a duty to defend”); *see also* *Liberty Mut. Fire Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 842 N.E.2d 170, 176 (Ill. App. Ct. 2005) (finding no estoppel because allegations “fell within the ‘completed operations’ exclusion”); *see also* *Legion Ins. Co. v. Empire Fire & Marine Ins. Co.*, 822 N.E.2d 1, 3, 7 (Ill. App. Ct. 2004) (concluding that although estoppel was sought, “Empire had no duty to defend”); *see also* *Progressive Ins. Co. v. Universal Cas. Co.*, 807 N.E.2d 577, 586 (Ill. App. Ct. 2004)(holding that a “factual dispute over” notice precluded summary judgment on effort to hold insurer “estopped from raising . . .

demonstrates that insurers willing to satisfy their promises have little to fear and much to gain from the rule.

IV. CONCLUSION

Although a minority position, the Illinois estoppel rule provides an important device for ensuring that insurers honor their fundamental defense obligations. This rule serves a crucial function in Illinois law, and it can provide an attractive option to serve the same function in other states. Courts outside Illinois law would do well to consider the merits of this rule for the enforcement of the duty to defend.

policy defenses.”); *see also* Am. Nat’l. Fire Ins. Co. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa., 796 N.E.2d 1133, 1143 (Ill. App. Ct. 2003) (deciding that although American claimed “National is estopped” its “duty to defend was never triggered.”); *see also* State Farm Ins. Co. v. Am. Serv. Ins. Co., 773 N.E.2d 666, 668 (Ill. App. Ct. 2002) (declaring that the trial court should have ruled on policy rescission before deciding American “breached its duty to defend . . . and was therefore estopped”); *see also* Liberty Mut. Ins. Co. v. Westfield Ins. Co., 703 N.E.2d 439, 441 (Ill. App. Ct. 1998) (noting that a motion claimed “Westfield was estopped” but argument that it “breached its duty to defend” had been rejected); *see also* Ill. Nat’l. Ins. Co. v. Universal Underwriters Ins. Co., 633 N.E.2d 1243, 1244, 1246-47 (Ill. App. Ct. 1994) (stating that plaintiffs claimed error “in finding that Universal was not estopped,” but “if there is no duty to defend, the estoppel rule is not applicable”); *see also* Employers Mut. Cos./Illinois Emcasco Ins. Co. v. Country Cos., 570 N.E.2d 528, 532 (Ill. App. Ct. 1991) (deciding insurer was not estopped where complaint alleged action “outside the potential coverage” of its policy); *see also* Allianz Versicherungs-Ag v. Federal Ins. Co., 557 N.E.2d 313, 315 (Ill. App. Ct. 1990) (ruling that because refusal to defend “was justified, it is unnecessary to address Allianz’s argument that Federal was estopped.”); *see also* Federal Ins. Co. v. Economy Fire & Cas. Co., 545 N.E.2d 541, 544, 546 (Ill. App. Ct. 1989) (holding that the argument “Economy should be estopped” was lost where underlying complaint did not allege “potential for coverage.”); *see also* Country Mut. Ins. Co. v. Millers Nat. Ins. Co., 534 N.E.2d 151, 156 (Ill. App. Ct. 1989) (observing that “Country Mutual asserts Millers National is estopped” but rule is inapplicable “where there is no policy in existence.”); *see also* Associated Indem. Co. v. Ins. Co. of N. Am., 386 N.E.2d 529, 539-43 (Ill. App. Ct. 1979) (holding that a “serious conflict of interest” precluded holding INA “estopped from raising non-coverage as a defense to Associated’s request for a declaration”).

