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INSURER'S DUTY TO DEFEND IN MARYLAND

Andrew Janquitto†

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I. INTRODUCTION

The standard liability insurance policy¹ provides both litigation and

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1. This article will concentrate on cases interpreting the duty-to-defend provision in a

liability protection for the insured. Each is an important benefit. The insurer's duty to defend relieves the insured of the expense of defending a suit and makes available the insurer's vast legal and investigative resources for the purpose of defeating the claim. The insurer's duty to indemnify relieves the insured of the obligation to settle a claim or pay a final judgment.

In Maryland, the duty to defend under the standard policy is determined by comparing the allegations in the claimant's pleadings to the coverage provisions of the policy.² If the allegations describe an injury which is within the scope of the insurer's duty to indemnify, then the insurer has a duty to defend.³ Moreover, if the allegations do not fall within the policy's coverage but create a *potential* that the insurer will have a duty to indemnify, then the insurer must defend. This is true even if the insurer possesses independent knowledge that no duty to indemnify actually exists. It is only when the allegations fall clearly outside the scope of the coverage and do not raise a potentiality of coverage that the insurer has no duty to defend.⁴

In recent years, Maryland courts have expanded the insurer's defense obligation to a point where the insurer has a near-absolute duty to defend whenever its insured is sued. This expansion is both appropriate and justified. As the drafter of the policy, the insurer could have limited

Comprehensive General Liability (C.G.L.) policy, which will be referred to as the standard liability policy. Reference to other duty-to-defend provisions will be made to highlight the fundamental elements of the standard provision. The C.G.L. policy provides:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of

A. bodily injury or

B. property damage

to which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient, but the company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.

For a discussion of the C.G.L. policy, see Sharpe & Shaffer, *The Parameters of An Insurer's Duty to Defend*, 19 FORUM 555 (1984).

2. St. Paul Fire & Marine Ins. Co. v. Pryseski, 292 Md. 187, 193-94, 438 A.2d 282, 285-86 (1981). This is known as the comparison test. See *Travelers Indem. Co. v. Dingwell*, 414 A.2d 220, 226 (Me. 1980).
3. *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 407-08, 347 A.2d 842, 850 (1975).
4. See *Mraz v. American Universal Ins. Co.*, 616 F. Supp. 1173, 1177 (D. Md. 1985) (citing *Minnick's, Inc. v. Reliance Ins. Co.*, 47 Md. App. 329, 333-34, 422 A.2d 1028, 1030 (1980)), *rev'd sub nom. on other grounds*, *Mraz v. Canadian Universal Ins. Co.*, 804 F.2d 1325 (4th Cir. 1986); *GEICO v. Ropka*, 74 Md. App. 249, 257, 536 A.2d 1214, 1218 (1987) ("It is generally true that an insurer has no duty to defend a cause of action against an insured if that cause of action asserts liability on the part of the insured that comes within an exclusion in the insurance policy."), *cert. denied*, 312 Md. 601, 541 A.2d 964 (1988).

its defense duty. Instead, the insurer bargained for the right to control the litigation and settlement process. In exchange, it promised to defend against groundless, false and fraudulent claims, and assumed the risk that its defense duty would arise because of ambiguous, incomplete or poorly drafted pleadings.

This article analyzes the nature, extent and the existence of the insurer's duty to defend in Maryland under the standard liability policy. This article also attempts to clarify the concept of "potentiality of coverage" by an extended examination of the "exclusive pleading rule," "the potentiality rule" and "the comparison test."⁵ Special attention is given throughout to Maryland case law, although reference to the approaches taken by other jurisdictions are made for purposes of comparison.⁶ In addition, the law of other jurisdictions is considered regarding issues not yet addressed by Maryland courts.

II. THE INSURER'S DUTY TO DEFEND

There is no duty to defend on the part of an insurer at common law.⁷ The duty is contractual and is best understood in simple contract terms.⁸ The insured pays a premium to the insurer. In return, he receives, as consideration, the insurer's promises to defend and to indemnify him.⁹ The insurer's basic responsibility under a standard liability

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5. The main focus of this article is on issues that arise from the concept of "potentiality of coverage." The insurer's duty to use reasonable care and good faith in defending a claim is discussed only briefly, and its duties to investigate, to pay undisputed claims, to settle claims within policy limits, and to indemnify are addressed only as they relate to the duty to defend. Similarly, the coordination of other insurance clauses, the duties and responsibilities running between concurrent insurers, and the ethical problems faced by insurance defense counsel are only briefly mentioned.
 6. The insurer's duty to defend has spawned extensive commentary. See, e.g., Cahoon, *Company's Duty to Defend—Recent Developments*, 1961 INS. L.J. 151; Dohoney, *The Liability Insurer's Duty to Defend*, 33 BAYLOR L. REV. 451 (1981); Garbett, *The Duty to Defend Clause in a Liability Insurance Policy: Should the Exclusive Pleading Test be Replaced?*, 36 U. MIAMI L. REV. 235 (1982); Comment, *The Insurer's Duty to Defend Under a Liability Insurance Policy*, 114 U. PA. L. REV. 734 (1966) [hereinafter Comment, *The Insurer's Duty*].
 7. See *Steyer v. Westvaco Corp.*, 450 F. Supp. 384, 389 (D. Md. 1978); *All-Star Ins. Corp. v. Steel Bar, Inc.*, 324 F. Supp. 160, 163 (N.D. Ind. 1971) (cited with approval by *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 411-12, 347 A.2d 842, 852 (1975)); *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 317, 475 A.2d 509, 514-15, cert. denied, 301 Md. 176, 482 A.2d 502 (1984).
 8. *Riviera Beach Volunteer Fire Co. v. Fidelity & Casualty Co.*, 388 F. Supp. 1114, 1120 (D. Md. 1975) (duty to defend is a contractual assumption). One commentator, however, has observed that liability insurance has evolved from a simple contractual agreement to a complex undertaking and that "most problems in liability insurance can no longer be viewed in a traditional contract analysis, but call for the application of tort doctrines, statutory construction and considerations of public policy." Comment, *Liability Insurers and Third-Party Claimants: The Limits of Duty*, 48 U. CHI. L. REV. 125, 125 (1981).
 9. *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 409, 347 A.2d 842, 851 (1975). In addition to paying a premium, the insured promises to notify the insurer of any claims and to cooperate with the insurer's investigation and defense of any claim.

policy "is to defeat or pay a claim within the policy's coverage."¹⁰ Thus, although the insurance is commonly known as liability insurance, it is in reality litigation insurance as well.¹¹

The duty to defend, being a contractual obligation, exists only to the extent that the policy requires the insurer to defend its insured. The standard policy states that "the company shall have the right and *duty* to defend any suit against the insured seeking damages on account of . . . bodily injury or property damage, even if any of the allegations of the suit are groundless, false or fraudulent."¹² If a policy does not contain a duty-to-defend provision, then there is no implied duty to defend.¹³ Similarly, a policy that gives the insurer the *right*, but not the *duty* to defend, may not create a duty to defend.¹⁴

Although the standard policy contains a defense duty, some types of policies do not. Excess policies,¹⁵ for example, often provide liability protection but no litigation protection.¹⁶ Furthermore, some primary policies,¹⁷ such as directors' and officers' liability policies, may contain a narrower duty to defend than is found in the standard policy. In such a case, Maryland courts will not infer a broader duty. In *Continental Casualty Co. v. Board of Education*,¹⁸ for example, the court of appeals observed that the provisions of the directors' and officers' liability policy under review were "substantially different from the duty to defend clause

Id.; see also *infra* notes 167-174 and accompanying text. The insurer's duties of defense and indemnification involve obligations to investigate, negotiate and settle claims. *Brohawn*, 276 Md. at 409, 347 A.2d at 851.

10. *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 389-90, 267 A.2d 7, 10 (1970).

11. See *Brohawn*, 276 Md. at 409-10, 347 A.2d at 851.

12. See *supra* note 1.

13. See *Steyer v. Westvaco Corp.*, 450 F. Supp. 384, 389-90 (D. Md. 1978). In *Steyer*, the court refused to recognize a duty to defend in a policy issued by the Home Insurance Company because of a provision expressly disclaiming the duty. *Id.* at 394. The court, however, did not address whether an implied duty to defend could exist where the policy did not contain an express disclaimer. But see *Conanicut Marine Servs., Inc. v. Insurance Co. of N. Am.*, 511 A.2d 967, 970 (R.I. 1986) (implied duty to defend found to exist because policy provided liability insurance and did not contain a provision negating duty to defend).

14. See *Liberty Mut. Ins. Co. v. Pacific Indem. Co.*, 579 F. Supp. 140, 144 (W.D. Pa. 1984).

15. Excess insurance, also known as secondary insurance, "attaches only after a predetermined amount of primary coverage has been exhausted." *Olympic Ins. Co. v. Employers Surplus Lines Ins. Co.*, 126 Cal. App.3d 593, 597-98, 178 Cal. Rptr. 908, 910-11 (1982) (quoted with approval in *United States Fire Ins. Co. v. Maryland Casualty Co.*, 52 Md. App. 269, 271-72, 447 A.2d 896, 898 (1982)). The *Olympic* court noted that "[i]t is not uncommon to have several layers of secondary insurance." *Id.* at 597-98, 178 Cal. Rptr. at 911.

16. See *Steyer v. Westvaco Corp.*, 450 F. Supp. 384 (D. Md. 1978); see also *supra* note 13.

17. Primary insurance is insurance which, under the terms of the policy, "attaches immediately upon the happening of the occurrence that gives rise to liability." *Olympic*, 126 Cal. App.3d at 597, 178 Cal. Rptr. at 910 (emphasis in original).

18. 302 Md. 516, 489 A.2d 536 (1985).

of a conventional liability policy.”¹⁹ The court held that the insurer's defense obligation extended only to claims that fell *actually* within coverage because (1) the policy did not give exclusive control of the litigation to the insurer, (2) it required the insured to retain its own counsel, and (3) it obligated the insurer to compensate the insured for those litigation expenses and attorney's fees incurred by the insured that were reasonably related to *covered* claims.²⁰

As *Continental* suggests, the most notable feature of the insurer's duty to defend under the standard policy is its application to claims that fall outside the policy's coverage. The insurer's duties to defend and to indemnify are distinct and independent obligations, related only in that they both depend on the scope of coverage.²¹ The insurer's obligation to defend claims which are “groundless, false or fraudulent”²² under the standard policy exemplifies what has been called the “most significant

19. *Id.* at 530, 489 A.2d at 543. The duty-to-defend provision provided that:

(a) The Assureds and/or the School District shall select and retain legal counsel to represent them in the defense and appeal of any claim, suit, action or proceeding covered under this policy, but no fees, costs or expenses shall be incurred or settlements made, without the Insurer's consent, such consent not to be unreasonably withheld.

(b) The Insurer may at its option and upon request, advance on behalf of an Assured, and/or the School District fees, costs and expenses which have been incurred in connection with claims made against an Assured, prior to disposition of such claims, provided always that, in the event it is finally established the Insurer has no liability hereunder, each agrees to repay to the Insurer, upon demand, all monies advanced on their behalf. . . .

Id. at 522, 489 A.2d at 539.

20. *Continental* argued that it did not have a duty to defend an entire multiple count complaint against its insured because the policy did not contain any duty-to-defend language, there was no obligation to defend groundless claims, and the insurer did not have the right to select counsel and control the litigation. *Id.* at 529, 489 A.2d at 542.

21. See *Steyer v. Westvaco Corp.*, 450 F. Supp. 384, 389 (D. Md. 1978). The duty to defend arises from a comparison of the claimant's allegations to the policy's coverage; the duty to indemnify arises from a comparison of the ultimate findings of fact in the underlying tort action to the policy's coverage. As the *Steyer* court noted, in contrast to the duty to defend, “the question whether the insurer has a duty to pay a final judgment against the insured turns on a comparison of the ultimate findings of fact concerning the alleged occurrence with the policy coverage.” *Id.* at 389; see also *Haines v. St. Paul Fire & Marine Ins. Co.*, 428 F. Supp. 435, 439 (D. Md. 1977); *Riviera Beach Volunteer Fire Co. v. Fidelity & Casualty Co.*, 388 F. Supp. 1114, 1120 (D. Md. 1975).

22. In *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 267 A.2d 7 (1970), the court construed the standard duty-to-defend provision as follows:

The obligation to defend ‘groundless, false or fraudulent’ claims does not mean that the carrier will defend claims which would be beyond the covenant to pay if the claimant prevailed. It means only that a carrier may not refuse to defend a suit on the ground that the claim asserted against the insured cannot possibly succeed because either in law or fact there is no basis for a plaintiff's judgment.

Id. at 389, 267 A.2d at 10. In *Oweiss v. Erie Ins. Co.*, 67 Md. App. 712, 509 A.2d 711 (1986), the court ruled that language in a duty-to-defend provision requiring the insurer to defend the insured “even if the allegations are not true” was the

difference"²³ between these two duties: the duty to defend is broader than the duty to indemnify.²⁴ Under the standard policy, the insurer's duty to defend imposes an obligation to defend the insured not only against claims that actually fall within the policy's coverage but also against any claim alleging facts that raise a potential duty to indemnify.²⁵

III. THE INQUIRY INTO THE DUTY TO DEFEND

The issue of whether an insurer has a duty to defend a particular claim made against its insured in Maryland has spawned extensive litigation and substantial confusion.²⁶ Most of the difficulties emanate from the "exclusive pleading rule," the "potentiality rule" and the "comparison test." All three of these concepts flow directly from the language in the standard duty-to-defend provision.²⁷ Language that varies from the standard provision, however, can invalidate any, or all, of these standard features.²⁸ A detailed analysis of the leading cases will highlight the in-

equivalent of the standard "groundless, false or fraudulent" language. *Id.* at 718, 509 A.2d at 714.

23. Sharpe & Shaffer, *supra* note 1, at 555-56.

24. This hornbook rule of law has been stated explicitly by only one court applying Maryland law. *See Western World Ins. Co. v. Harford Mut. Ins. Co.*, 600 F. Supp. 313, 321 (D. Md. 1984) ("the obligation to defend is broader than the obligation to pay a final judgment"), *aff'd in part and rev'd in part*, 784 F.2d 558 (4th Cir. 1986). The rule, however, is implied in numerous decisions.

25. *See Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 320, 475 A.2d 509, 516, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984).

26. In general terms, the inquiry into the duty to defend involves four separate questions: (1) is there a duty?; (2) what is the duty?; (3) what is the scope of the duty?; and (4) does the claim give rise to the duty? The first three questions focus on the insurance policy, the fourth on the claim. In *St. Paul Fire & Marine Ins. Co. v. Pryseski*, 292 Md. 187, 438 A.2d 282 (1981), the court saw only two inquiries that needed to be made when considering a duty-to-defend question. *Id.* at 197, 438 A.2d at 287. The court found it unnecessary to discuss either the existence of a duty-to-defend provision or the type of defense duty because the St. Paul policy contained the standard duty-to-defend provision. The *Pryseski* comparison test, in essence, comprises steps three and four in the four-step inquiry.

27. The standard policy provision invokes both the exclusive pleading rule and the comparison test by obligating the insurer "to defend any *suit* against the insured seeking damages on account of such bodily injury or property damage." *See supra* note 1. The qualifying clause that the duty applies "even if any of the *allegations of the suit* are groundless, false or fraudulent" buttresses this conclusion. *See supra* note 1; *see also Dohoney, supra* note 6, at 452. The "potentiality rule" arises from language that extends the insurer's obligation to defend against "groundless, false or fraudulent" suits, but gives the insurer the power to "make such investigation, negotiation and settlement of any claims as it deems expedient." *See supra* note 1.

28. In *Steyer v. Westvaco Corp.*, 450 F. Supp. 384 (D. Md. 1978), the court refused to recognize a duty to defend in a policy issued by the Home Insurance Company because of a provision expressly disclaiming the duty. The court noted that:

One significant consequence of this ruling that there is no duty to defend is to make inapplicable the rule in a duty to defend situation that the liability of the insurer to defend is determined by comparison of the allegations in the complaint against the insured with the terms of the insurance policy.

Id. at 394; *see also Continental Casualty Co. v. Board of Educ.*, 302 Md. 516, 489 A.2d 536 (1985) (exclusive pleading rule, potentiality rule and comparison test inva-

tricacies and interplay of these rules.

A. *The Lee Cases and the Exclusive Pleading Rule*

Maryland, like the majority of states,²⁹ follows the exclusive pleading rule³⁰ in determining whether an insurer has an obligation to defend its insured against a claimant's claim. The exclusive pleading rule holds that an insurer's defense obligation is determined solely by the allegations against the insured in the claimant's pleadings. Under this rule, information extrinsic to the pleadings is not relevant in determining the insurer's defense obligation.³¹

The exclusive pleading rule has a long tradition.³² Perhaps the case most often cited for the proposition that the insurer's defense obligation is to be determined solely by the allegations in the claimant's pleadings is the Second Circuit's decision in *Lee v. Aetna Casualty & Surety Co.*³³ which has been quoted with approval by Maryland courts.³⁴ In *Lee*, the claimant, a customer in a pet store, sued the store for personal injuries after he fell down an elevator shaft. Aetna, the store's insurer, discovered through its investigation that the claimant had fallen while trying to use the elevator. Aetna refused to defend even though the policy contained a standard duty-to-defend provision, because coverage for liability arising out of the use of an elevator was excluded. The complaint, however, alleged only that the claimant had fallen down the elevator shaft as a result of the insured's negligence; it did not explicitly state that the claimant was attempting to use the elevator when the accident occurred.³⁵

Aetna argued that it had no duty to defend because the actual facts of the tort action unequivocally showed that the claimant's injuries were excluded from coverage. The insured argued that the insurer's duty to defend rested on the claimant's allegations and that the insurer was not allowed to look beyond the four corners of the complaint in order to

lid because directors' and officers' liability policy does not contain a duty-to-defend provision similar to the standard policy).

29. See Annotation, *Allegations in Third Person's Action Against Insured as Determining Liability Insurer's Duty to Defend*, 50 A.L.R.2d 458 (1956).

30. The majority rule has been called several different names. Compare Garbett, *supra* note 6 ("exclusive pleading test") with Dohoney, *supra* note 6 ("complaint allegation rule"). The exclusive pleading rule is used in this article because it appears to be the most accurate description, especially in light of Maryland Rules 1-202(r) and 2-302, which define a pleading as a complaint, an answer, a counterclaim, a cross-claim, or a third-party complaint. See Md. R. 1-202(r), 2-302. The concept that an insurer's duty to defend may be determined only by the allegations in the claimant's pleadings is also more properly categorized as a rule than a test.

31. See *Western World Ins. Co. v. Harford Mut. Ins. Co.*, 784 F.2d 558, 562 (4th Cir. 1986).

32. See Cahoon, *supra* note 6, at 151.

33. 178 F.2d 750 (2d Cir. 1949).

34. See, e.g., *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 408, 347 A.2d 842, 850 (1975).

35. *Lee*, 178 F.2d at 753.

determine its defense obligation.³⁶ The Second Circuit agreed with the insured, holding that the insurer's promise to defend groundless, false or fraudulent suits meant:

[T]hat the insurer will defend the suit, if the injured party states a claim, which, qua claim, is for an injury 'covered' by the policy; it is the claim which determines the insurer's duty to defend; and it is irrelevant that the insurer may get information from the insured, or from anyone else, which indicates, or even demonstrates, that the injury is not in fact 'covered.'³⁷

The holding in *Lee*,³⁸ according to one commentator, "firmly established" the exclusive pleading rule in American insurance law.³⁹

Maryland has recognized the exclusive pleading rule. One court has even called it a black letter rule of Maryland insurance law,⁴⁰ and exceptions to or deviations from the rule have been rejected repeatedly.⁴¹ In *Ohio Casualty Insurance Co. v. Lee*,⁴² for example, an employee of the insured, sued the manufacturers of an underground tank that had exploded and injured him. The manufacturers then filed third-party claims for indemnity and contribution against the insured and Lee, who was a director, stockholder and president of the insured. The third-party complaints alleged that Lee had negligently installed the underground storage tank, but they did not allege in what capacity Lee had acted when he installed the tanks. Under the policy, Lee was covered only if he acted as a director or stockholder.⁴³

Ohio Casualty denied coverage because its investigation revealed

36. *Id.* at 751-52.

37. *Id.* at 751. The converse of this statement is not necessarily true. If the pleadings do not allege coverage but the insurer has facts that show coverage, then the insurer is generally obligated to defend. See *infra* text accompanying notes 257-275.

38. The complaint raised a potentiality of coverage because there was a possibility that the claimant had not been using the elevator when he fell down the shaft. If the complaint had expressly alleged that the plaintiff was "using" the elevator when he fell, then the insurer would not have had a duty to defend the insured. The facts established at trial showed that the plaintiff was indeed "using" the elevator when he fell down the shaft, and consequently Aetna had no duty to indemnify even though it had a duty to defend. *Lee*, 178 F.2d at 751-52.

39. Garbett, *supra* note 6, at 239.

40. *Maryland Casualty Co. v. Armco, Inc.*, 643 F. Supp. 430, 434 (D. Md. 1986), *aff'd*, 822 F.2d 1348 (4th Cir. 1987), *cert. denied*, 108 S. Ct. 703 (1988).

41. See, e.g., *Western World Ins. Co. v. Harford Mut. Ins. Co.*, 784 F.2d 558, 562 (4th Cir. 1986) (court specifically rejected the position that "an insurer can also look to the actual facts surrounding an event to determine whether or not coverage exists, and consequently to discern whether the insured has the duty to defend").

42. 62 Md. App. 176, 488 A.2d 988, *cert. denied*, 303 Md. 471, 494 A.2d 939 (1985).

43. *Id.* at 181, 488 A.2d at 990. For a discussion of the nature, scope and validity of "co-employee" exclusions in an insurance policy, see *Larimore v. American Ins. Co.*, 69 Md. App. 631, 519 A.2d 743 (1987), *rev'd*, 314 Md. 617, 552 A.2d 889 (1989). See also *Riviera Beach Volunteer Fire Co. v. Fidelity & Casualty Co.*, 388 F. Supp. 1114 (D. Md. 1975); *Bevans v. Liberty Mut. Ins. Co.*, 356 F.2d 577 (4th Cir. 1966).

that the only possible capacity in which Lee could have acted when he installed the tanks was as the insured's president. The court of special appeals held that Ohio Casualty had an obligation to defend Lee even when it appeared from extrinsic evidence that Lee was excluded from coverage.⁴⁴ According to the court, Ohio Casualty's contractual obligation to defend rested exclusively on the claimant's pleadings, and extrinsic evidence could not be used to negate that duty.⁴⁵

Although neither of the *Lee* courts discussed the rationale behind the exclusive pleading rule, both suggest that the language of the standard duty-to-defend clause provides that the insurer must determine its duty on the basis of the allegations in the claimant's pleadings.⁴⁶ The

44. The court observed:

In the case *sub judice*, Ohio Casualty's belief as to the capacity in which Lee acted will not relieve it of its duty to defend Lee. Nor can Ohio Casualty gain solace from the fact that there does not appear to be any basis for a claim based on a capacity other than president. It undertook to defend its insured against *suits alleging* bodily injury and seeking damages even if the allegations of the suit are groundless, false or fraudulent.

Ohio Casualty, 62 Md. App. at 189-90, 488 A.2d at 995 (emphasis added) (footnote omitted). The claimants' pleadings raised a potential that Ohio Casualty would have a duty to indemnify Lee because the fact finder could have determined that Lee acted as a director or stockholder when he installed the tanks. See *infra* text accompanying notes 52-84.

45. *Ohio Casualty*, 62 Md. App. at 187-90, 488 A.2d at 994-95. The court of special appeals noted that "evidence concerning Lee's duties would be admissible and utilized by the trier of fact to determine the capacity in which he acted." *Id.* at 188 n.16, 488 A.2d at 994 n.16. The court then concluded that:

[T]he trier of fact would have to determine if Lee were acting as a director, as a stockholder, or as an employee performing the non-delegable duty of his employer, or if he was acting solely in the capacity of president of Auto Clean, therefore, as an employee. If it were to find the former, Lee would be covered under the policy of insurance. Conversely, if it were to find the latter, Lee would not be covered. In short, there is a 'potentiality' of coverage.

Id. at 187-89, 488 A.2d at 994. The court's statement that Lee would have been covered under the policy had he been acting as an employee performing a non-delegable duty is incorrect. The co-employee exclusion applies to all employees acting within the scope of their employment. Including an employee who is performing a non-delegable duty defeats the very purpose of the co-employee exclusion. It is obvious that the *Ohio Casualty* court confuses the difference between insurance coverage and tort liability. Lee, as either a mere employee or an employee performing a non-delegable duty, is excluded from coverage. As an employee performing a non-delegable duty, however, Lee would enjoy tort immunity under the Maryland Workers' Compensation Act. MD. ANN. CODE art. 101, § 58 (1985); see also *Athas v. Hill*, 300 Md. 133, 476 A.2d 710 (1984). The potentiality for indemnification in *Ohio Casualty* arose because the complaint was silent as to whether Lee was functioning in his capacity as an employee (*i.e.*, as president) or as a director or stockholder when he installed the tanks. It did not arise because the complaint was silent as to whether Lee was functioning as a mere employee or as an employee performing a non-delegable duty.

46. See *supra* note 27 and accompanying text; see also *All-Star Ins. Corp. v. Steel Bar, Inc.*, 324 F. Supp. 160, 163 (N.D. Ind. 1971) ("If the parties had so intended, the insurance policy could have been drafted so as to predicate the duty of the insurer to defend upon a determination that the facts of the case actually were within the

rule is also justified on several other grounds. Above all else, it is easy, efficient and objective.⁴⁷ Abrogation of the exclusive pleading rule, as one commentator has phrased it, "would require the parties to the insurance contract to exercise clairvoyance in order to determine their respective rights and liabilities, since there would be no objective . . . basis—such as reference to the [claimant's] pleadings—for determining these rights."⁴⁸

In Maryland, the duty to defend can arise out of any type of original or amended pleading.⁴⁹ While it is obvious that an original or amended complaint, counter-claim, cross-claim or third-party claim can give rise to a duty to defend, it is less obvious, but still technically possible, that an opposing party's original or amended answer can also give rise to the duty if the answer actually constitutes a counterclaim.⁵⁰ When an original pleading does not raise a duty to defend but a subsequent pleading does, the insurer's defense duty does not arise unless, and until, the insurer is notified of the subsequent pleading and asked to assume the defense.⁵¹

B. Brohawn and the Potentiality Rule

Perhaps the most important and most misunderstood aspect of an insurer's duty to defend its insured is the concept of "potentiality of coverage." The court of special appeals has recognized the confusion that surrounds the concept of "potentiality of coverage" by noting that it is only a "somewhat distinct standard."⁵² The duty to defend all claims

coverage of the policy. Since the policy makes the duty to defend rest upon the allegations of the injured party, the Court has no authority to look beyond the allegations to the actual facts."); *Travelers Ins. Co. v. Newsom*, 352 S.W.2d 888, 893 (Tex. Civ. App. 1981) ("We pose the question: Why is the duty of the insurer to defend determinative of the allegations in the third party's complaint? We answer our own question with the very logical conclusion that the contract so provides. . . . That is the coverage paid for by the insured.").

47. Dohoney states that the exclusive pleading rule "is clearly a mechanical one and, therefore, should present little difficulty for courts attempting to determine the liability insurer's obligation to defend under most . . . policies." Dohoney, *supra* note 6, at 453. Garbett, while questioning the validity of the rule in some contexts, admits that it affords "efficiency, ease of application, and objectivity." Garbett, *supra* note 6, at 261.
48. Dohoney, *supra* note 6, at 455.
49. Maryland Rules 1-202(r) and 2-302(a) define a pleading as a complaint, an answer, a counterclaim, a cross-claim or a third-party complaint. MD. R. 1-202(r), 2-302(a). Under Maryland Rule 2-341 amendments of pleadings are freely allowed. MD. R. 2-341.
50. Maryland Rule 2-323(g) provides that "[w]hen a party has mistakenly designated . . . a counterclaim as a defense, the court shall treat the pleading as if there had been a proper designation, if justice so requires." MD. R. 2-323(g).
51. See *Oweiss v. Erie Ins. Exch. Co.*, 67 Md. App. 712, 718-19, 509 A.2d 711, 714-15 (1986); see also *Washington v. Federal Kemper Ins. Co.*, 60 Md. App. 288, 482 A.2d 503 (1984), *cert. denied*, 302 Md. 289, 487 A.2d 292 (1985).
52. *Travelers Indem. Co. v. Insurance Co. of N. Am.*, 69 Md. App. 664, 671, 519 A.2d 760, 764 (1987). This confusion possibly arises because the term "coverage" has

which potentially come within policy coverage was fully articulated in *Brohawn v. Transamerica Insurance Company*.⁵³ There, the coverage issue arose out of an altercation at a nursing home when Mary Brohawn tried to remove her grandmother from the home.⁵⁴ Several employees of the home questioned the appropriateness of the removal and attempted to prevent it. An argument ensued, and Brohawn allegedly assaulted two of the employees.⁵⁵ Brohawn was arrested and charged with kidnapping and assault. She pleaded guilty to the assault charge and the kidnapping charge was dismissed. Several months later, the two employees filed a civil suit against Brohawn for assault.⁵⁶ Subsequently, the suit was amended by addition of a count which alleged that the employees' injuries were caused by Brohawn's negligence.

At the time of the incident at the nursing home, Brohawn was insured by Transamerica Insurance Company under a homeowner's policy that contained a variation of the standard duty-to-defend provision.⁵⁷

several different meanings. In *All-Star Ins. Corp. v. Steel Bar, Inc.*, 324 F. Supp. 160 (N.D. Ind. 1971), the court stated:

Whether an insurance policy 'covers' a particular incident depends initially upon whether the contract is in force (e.g., whether premiums have been paid), whether the conditions precedent have been met (e.g., whether the insured notified the insurer of the accident), and whether the incident falls within a specific exclusion in the policy (e.g., where the driver of an automobile was not legally authorized to drive a car). If there is no 'coverage' in the sense used here, the Court never reaches the problems of determining the duty to defend or duty to pay under the contract since the contract does not even apply in such a situation. . . .

If it is determined that the contract does apply, the Court must then look to 'coverage' in a different sense to determine the duties of the insurer under the policy. There are two types of 'coverage' which are involved here. There is the question of whether the risk insured against encompasses the facts of the accident *as alleged*. There is also the question of whether *in fact* the occurrence was of the type insured against. In this latter sense, 'coverage' is synonymous with liability to pay.

Id. at 162 (emphasis in original).

53. 276 Md. 396, 409-10, 347 A.2d 842, 850-51 (1975). The potentiality rule was first articulated in *United States Fidelity & Guar. Co. v. National Paving & Contracting Co.*, 228 Md. 40, 54, 178 A.2d 872, 879 (1962).
54. *See Transamerica Ins. Co. v. Brohawn*, 23 Md. App. 186, 187-91, 326 A.2d 758, 760-62 (1974), *rev'd*, 276 Md. 396, 347 A.2d 842 (1975).
55. *Id.* at 188-89, 326 A.2d at 760-61. The facts of the case suggest that the court used the term "assault" to refer to both an assault and a battery. The term is used in this context in this article.
56. The complaint sought compensatory and punitive damages and alleged that "Brohawn . . . did 'with force and arms, willfully and maliciously and without any just cause or provocation' assault them, resulting in 'serious, painful and permanent injuries.'" *Brohawn*, 276 Md. at 399, 347 A.2d at 846 (quoting complaint).
57. The duty-to-defend provision was contained in the "Comprehensive Personal Liability" section of the policy, under which the insurer agreed:

To pay on behalf of the Insured all sums which the Insured shall become legally obligated to pay as damages because of bodily injury or property damage, and the Company shall defend any suit against the Insured alleging such bodily injury or property damage and seeking damages which are payable under the terms of this Section, even if any of the allegations of the

The policy excluded coverage for "any act committed by or at the direction of the Insured with intent to cause injury to person or property."⁵⁸ Transamerica refused to defend Brohawn and requested a declaratory judgment that it had no obligation either to defend or to indemnify Brohawn in the underlying tort action.

The trial court denied Transamerica's request for a declaratory judgment, held that the indemnity issue would be decided by the jury's verdict on the issues in the underlying tort suit and ordered Transamerica to defend Brohawn.⁵⁹ Transamerica appealed, arguing that it had no duty to defend Brohawn because her guilty plea in the criminal trial had established that any injuries received by the plaintiffs in the tort suit were the result of intentional acts by Brohawn.⁶⁰ In addition, Transamerica argued that even if it had an obligation to defend Brohawn, it should be relieved of that duty because of conflict of interest and possible prejudice.⁶¹

The court of appeals first addressed the obligations imposed by the standard duty-to-defend provision:

The obligation of an insurer to defend its insured under a contract provision such as here involved is determined by the allegations in the tort actions. If the plaintiffs in the tort suits allege a claim covered by the policy, the insurer has a duty to defend. . . . Even if a tort plaintiff does not allege facts which

suit are groundless, false or fraudulent; but the Company may make such investigation and settlement of any claim or suit as it deems expedient.

Id. at 400, 347 A.2d at 846 (emphasis in original). Note the difference between the duty-to-defend language in the Brohawn policy (any suit against the insured *alleging* such bodily injury) and the language in the C.G.L. policy (any suit against the insured *seeking damages*). See *supra* note 1. Dohoney argues that the difference does not affect the validity of the exclusive pleading rule. Dohoney, *supra* note 6, at 454-55.

58. *Brohawn*, 276 Md. at 400, 347 A.2d at 846.

59. *Id.* at 401-02, 347 A.2d at 846-47. The *Brohawn* court's holding that the issue of whether Brohawn acted negligently or intentionally would be decided in the underlying tort action implicitly recognizes the use of special jury questions. See MD. R. 2-522(c). For an example of special jury questions in a tort action involving alternative theories of negligence and intentional torts, see *Allstate Ins. Co. v. Atwood*, 71 Md. App. 107, 523 A.2d 1066, *cert. granted*, 310 Md. 274, 528 A.2d 1286 (1987). Insurance defense counsel, however, should be cautious about using special jury questions in a conflict-of-interest situation. If the insured has consented to the insurer's selection of independent counsel, then the independent counsel's use of special jury questions may violate the duties of loyalty he owes to the insured. See generally Williams & Jernberg, *Conflicts of Interest in Insurance Defense Litigation: Common Sense in Changing Times*, 31 FED'N INS. COUNS. Q. 111 (1981). If the defense counsel thinks that the special jury questions are in the best interests of the insured, he should fully explain the nature, purpose and consequences—both in tort liability and insurance coverage contexts—of the questions to the insured. He should then obtain the insured's express written permission to use the questions and notify the insurer of his intention to use them.

60. *Brohawn*, 276 Md. at 403, 347 A.2d at 847.

61. *Id.* at 410-15, 347 A.2d at 852-54. For a discussion of the conflict of interest between the insurer and the insured, see *infra* text accompanying notes 175-205.

clearly bring the claim within or without the policy coverage, the insurer still must defend if there is a *potentiality* that the claim could be covered by the policy.⁶²

According to the court, the insurer's obligation was to defend any suit stating a claim within the policy even when "the claim asserted against the insured cannot possibly succeed because either in law or fact there is no basis for a plaintiff's judgment."⁶³ Even though Brohawn had pleaded guilty to the criminal assault charge, that plea was not binding in the civil action, and the fact finder in the civil action could have decided that Brohawn acted negligently, not intentionally. Thus, a potentiality of coverage existed.

The court also specifically rejected Transamerica's argument that performance of its obligation to defend was made more difficult because of the evidence that Brohawn's acts were intentional.⁶⁴ Similarly, the court found that the insurer was not relieved of its defense obligation because of the conflict of interest between it and the insured.⁶⁵ Noting that unexpected difficulty does not discharge a promisor from his duty to perform, the court concluded that "[t]he insurer has unconditionally promised to defend the insured and therefore has assumed the risk that performance might be more difficult under some circumstances than others."⁶⁶ In the court's view, the insurer's promise to defend its insured "unconditionally" was made in exchange for the absolute right to control the defense. Requiring the insurer to defend comported with the expectations of the insured that the insurer would "employ its vast legal and investigative resources to defeat the action for the mutual benefit of both the insurer and the insured."⁶⁷

Brohawn and its progeny make clear that any potentiality of cover-

62. *Brohawn*, 276 Md. at 407-08, 347 A.2d at 850 (emphasis in original) (citations omitted).

63. *Id.* at 408-09, 347 A.2d at 850 (quoting *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 267 A.2d 7 (1970)).

64. Transamerica also sought to stay the underlying tort action until the declaratory judgment action had been resolved. The court of appeals rejected Transamerica's position, holding that the trial court had correctly denied Transamerica's request for declaratory relief on the grounds that the "ultimate issue" of whether Brohawn had acted negligently or intentionally would be fully decided in another pending action. *Id.* at 405, 347 A.2d at 849; see also *infra* notes 100-103 and accompanying text.

65. *Brohawn*, 276 Md. at 414-15, 347 A.2d at 854. The court held that when such a conflict arises, the insurer must give the insured a choice of accepting the insurer's independent counsel or retaining his own counsel. If the insured retains his own attorney, then the insurer is obligated to reimburse the insured for reasonable litigation expenses and attorney's fees. *Id.*; see also *infra* text accompanying notes 175-205.

66. *Brohawn*, 276 Md. at 410, 347 A.2d at 851.

67. *Id.* While Maryland courts have not embraced the doctrine of reasonable expectations, they have considered the insured's expectations in determining the intent of the parties to an insurance contract. See *infra* notes 264-267 and accompanying text. For a general discussion of the doctrine of reasonable expectations, see 1A R. LONG & M. RHODES, *THE LAW OF LIABILITY INSURANCE* § 5.09 (1987).

age, no matter how slight, gives rise to a duty to defend. The potentiality rule, in this regard, is perhaps better labeled the "possibility rule,"⁶⁸ and courts have characterized it as such.⁶⁹ The defense obligation extends even to those claims filed in bad faith for the sole purpose of raising a potentiality of coverage. For example, a claimant may add a negligence count to a pleading in order to create a *Brohawn* potentiality for the purpose of bringing the insurer into the case, even if there is little, if any, basis for the negligence count. Similarly, an insured's attorney may ask the claimant's attorney to amend a pleading to include a negligence count.⁷⁰ While some courts have relieved an insurer of its duty to defend bad-faith potentiality claims, the better reasoned rule is that the insurer remains obligated to defend.⁷¹ The promise to defend groundless, false or fraudulent claims is clearly broad enough to include defending the insured against allegations made for the sole purpose of invoking the insurer's duty to defend.⁷²

68. In *Employers Mut. Liab. Ins. Co. v. Hendrix*, 199 F.2d 53 (4th Cir. 1952), the court characterized the rule in the following manner:

[I]n our opinion the policy should be so construed as to require the insurer to defend where it is apparent from the pleading that there is a *reasonable possibility* that the insured may be able, under the allegations of the complaint, to prove that his injuries were caused by some act or omission covered by the terms of the contract.

Id. at 56 (emphasis added).

69. See, e.g., *Western World Ins. Co. v. Harford Mut. Ins. Co.*, 784 F.2d 558, 562 (4th Cir. 1986) (applying Maryland law) (complaint left open "the *possibility* that [the insured] acted negligently rather than intentionally" (emphasis added)).

70. See Browne, *The Demise of the Declaratory Judgment Action as a Device for Testing the Insurer's Duty to Defend: A Postscript*, 24 CLEV. ST. L. REV. 18, 27 (1975); see also *Oweiss v. Erie Insurance Exchange Co.*, 67 Md. App. 712, 509 A.2d 711 (1986). In *Oweiss*, the insurer argued that the claimant and the insured had contrived to include a negligence count in an amended complaint, and that as a consequence the company was relieved of its duty to defend. The court rejected the insurer's position for lack of evidence, but the decision implicitly left open the possibility that, in a proper case, either collusion between an insured and the claimant or the claimant's bad-faith inclusion of a count raising a potentiality of coverage would relieve an insurer of its duty to defend.

71. See A. WINDT, *INSURANCE CLAIMS AND DISPUTES: REPRESENTATION OF INSURANCE COMPANIES AND INSURED* § 4.04, at 139-40 (2d ed. 1988). But see *State Farm Ins. Co. v. Trezza*, 121 Misc. 2d 997, 1001, 469 N.Y.S.2d 1008, 1012 (N.Y. Sup. Ct. 1983) (if insurer believes a complaint "has been drafted in bad faith and designed solely to bring an insurer into a case," it can institute a declaratory judgment action against the claimant "to test the factual allegations of the complaint in the underlying [tort] action").

72. In such a situation the insurer would have recourse against the claimant and his attorney under Maryland Rule 1-341, which provides:

In any civil action, if the court finds that the conduct of any party in maintaining or defending any proceeding was in bad faith or without substantial justification the court may require the offending party or the attorney advising the conduct or both of them to pay to the adverse party the costs of the proceeding and the reasonable expenses, including reasonable attorney's fees, incurred by the adverse party in opposing it.

MD. R. 1-341. Moreover, if the insurer has offered a defense to the insured but the insured has colluded with the claimant to create a potentiality issue where the facts

There are several ways for claims to fall potentially within the coverage of a policy. In a *Brohawn*-type complaint, there is one count for negligence and one count for an intentional tort. The former is within coverage; the latter is not. The insurer is obligated to defend because the fact finder could decide that the insured's actions were negligent, not intentional, thus keeping the claim within coverage. The *Brohawn* potentiality rule, however, is applicable not only to a multiple-count pleading that alleges negligence and an intentional tort as alternative theories of recovery, but also to any pleading containing allegations that, if proved, will establish liability within the policy's coverage.⁷³

A potentiality of coverage can also arise because of ambiguous allegations. In *Southern Maryland Agricultural Association v. Bituminous Casualty Corp.*,⁷⁴ for example, the allegations in the complaint did not state with precision whether a malicious prosecution had occurred during the applicable policy dates. The court held that the incomplete allegations in the complaint raised a potentiality of coverage and required the insurer to defend.⁷⁵ Similarly, in *Harford Mutual Insurance v. Jacobson*,⁷⁶ a potentiality of coverage arose because of vague allegations.⁷⁷ Harford had attempted to withdraw its defense because its investigation showed that the lead poisoning injuries alleged in the complaint fell outside of the applicable dates of the policy period.⁷⁸ In holding that

do not justify it, the insurer may be able to assert a breach of the insured's duty to cooperate. See *Newman v. Stocker*, 161 Md. 552, 157 A. 761 (1932); *Anderson & Ireland Co. v. Maryland Casualty Co.*, 123 Md. 67, 90 A. 780 (1914) (discussion of insured's collusion with claimant as possible breach of insured's duty to cooperate with the insurer).

73. See, e.g., *Minnick's, Inc. v. Reliance Ins. Co.*, 47 Md. App. 329, 333-34, 422 A.2d 1028, 1030 (1980) (claim for loss of consortium in multiple-count complaint gives rise to a potentiality of coverage); see also *St. Paul Fire & Marine Ins. Co. v. Pryseski*, 292 Md. 187, 438 A.2d 282 (1981) (potentiality of coverage was raised where question whether insurer had duty to indemnify was for the factfinder). For an extended discussion of *Pryseski*, see *infra* text accompanying notes 85-118.

74. 539 F. Supp. 1295 (D. Md. 1982).

75. *Id.* at 1304. The court concluded that "[t]he question whether the 'offense' was actually committed during the policy period, so as to indicate coverage under the first *Pryseski* inquiry, is so 'intertwined' with the second inquiry that it must be resolved in the underlying suit." *Id.* (emphasis in original).

76. 73 Md. App. 670, 536 A.2d 120, *cert. denied*, 312 Md. 601, 541 A.2d 964 (1988).

77. *Keisha Carter* and her mother sued *Jacobson*, who was acting as the personal representative of the estate of *Israel Shapiro*, for personal injuries *Keisha* received from eating lead paint chips in a rental house owned by *Shapiro's* estate. The complaint alleged "that at or about 1981 *Keisha Carter* consumed lead paint chips and subsequently became ill." *Id.* at 675, 536 A.2d at 122. The complaint also alleged that *Keisha Carter* "has required extensive and continuous medical care, attention and treatment . . . [and] . . . is still receiving treatment." *Id.* at 675, 536 A.2d at 122-23. At the time the *Carter* complaint was filed in November 1983, *Shapiro's* estate was insured by *Harford Mutual* against claims arising out of the ownership of the rental house. The *Harford* policy took effect on June 3, 1983. *Harford's* investigation of the claim discovered that *Keisha Carter* was afflicted with lead poisoning as early as September 8, 1982. *Id.* at 674, 536 A.2d at 122.

78. "Bodily injury" was defined in the policy as "bodily injury, sickness or disease sus-

Harford had a duty to defend its insured, the court of special appeals first noted that "while Harford may believe that the incidents giving rise to liability preceded the date the policy became effective . . . this belief will not relieve it of its duty to defend its insured."⁷⁹ The court then decided that the vagueness of such phrases in the complaint as "*at or about,*" "*subsequently became ill,*" "*has required . . . continuous medical care, attention and treatment*" and "*is still receiving treatment,*" coupled with allegations that notice of a lead paint housing code violation had been issued during the policy period, created a potentiality that the occurrence happened within the policy period and gave rise to a duty to defend.⁸⁰

A clear and unmistakable implication of *Brohawn* and its progeny is that the duty to defend exists unless it can be conclusively shown *as a matter of law* that there is no possible factual or legal basis on which the insurer may eventually be found liable under its duty to indemnify.⁸¹ In analyzing a pleading, then, three maxims should guide the inquiry into whether the allegations create a potentiality that the insurer will have a duty to indemnify. First, if there is a reasonable possibility that the allegations raise a claim within the scope of the insurer's duty to indemnify, the insurer must defend. Second, the insured's right to a defense should be foreclosed only if the pleadings indicate that "such a result is inescapably necessary."⁸² Finally, if there is any doubt as to "whether or not the allegations . . . against the insured state a cause of action within the coverage of a liability policy sufficient to compel the insurer to defend the action, such doubt will be resolved *in [the] insured's favor.*"⁸³ The gen-

tained by any person *which occurs during the policy period.*" *Id.* at 680, 536 A.2d at 125 (emphasis in original).

79. *Id.* at 678, 536 A.2d at 124.

80. *Id.* at 675-79, 536 A.2d at 122-24 (emphasis added). The court, however, found that Harford had no duty to indemnify Jacobson because evidence adduced during the declaratory judgment action showed that although Keisha Carter's injuries had persisted into the period of coverage under the Harford policy, "her injuries first manifested themselves *prior* to coverage when she was diagnosed in 1982 by the Baltimore City Health Department as having lead poisoning." *Id.* at 684, 536 A.2d at 127. In the court's view, the date of an "occurrence" for the purposes of determining coverage under the standard liability policy was the date when the harm was first discovered. *Id.* at 684, 536 A.2d at 127. Thus, Carter's claim "occurred" before the policy became effective and, accordingly, was beyond the risk undertaken by the insurer.

81. *Pennsylvania Aluminum, Inc. v. Aetna Casualty & Sur.*, 61 A.D.2d 1119, 402 N.Y.S.2d 877 (1978) (New York rule).

82. *See Donnelly v. Transportation Ins. Co.*, 589 F.2d 761, 765 (4th Cir. 1978) ("[W]ith the great latitude with which pleadings are construed today, and the great latitude of amendment, an insured's right to a defense should not be foreclosed unless such a result is inescapably necessary.").

83. *United States Fidelity & Guar. Co. v. National Paving & Contracting Co.*, 228 Md. 40, 54, 178 A.2d 872, 879 (1962) (quoting Annotation, *Allegations in Third Person's Action Against Insured as Determining Liability Insurer's Duty to Defend*, 50 A.L.R.2d 458 (1956)) (emphasis added by the court). This is, essentially, the application of the doctrine of *contra proferentem* to the comparison test. *See Babcock & Wilcox Co. v. Parsons Corp.*, 430 F.2d 531, 536 (8th Cir. 1970) (The comparison test developed when pleading was required to be more specific; under notice plead-

eral, overriding rule for an insurer to follow is, as one commentator has phrased it, "when in doubt, defend."⁸⁴

C. *Pryseski and the Comparison Test*

Although the *Brohawn* court established that an insurer has a duty to defend a claim that comes potentially within the policy's coverage, it did not set out any express guidelines for determining when a potentiality of coverage actually exists. In *St. Paul Fire & Marine Insurance Co. v. Pryseski*,⁸⁵ the Court of Appeals of Maryland again had the opportunity to consider the potentiality issue, and this time it delineated a practical approach to the problem.

The insurance coverage dispute in *Pryseski* arose out of a personal injury suit brought by Mr. and Mrs. Grantland against Charles Pryseski and Sun Life Insurance Company of America. The plaintiffs alleged that Pryseski had made sexual advances toward Mrs. Grantland while he was at her home collecting a monthly insurance premium for his employer, Sun Life.⁸⁶ St. Paul insured Sun Life under a comprehensive liability policy that provided personal injury coverage⁸⁷ and contained the standard duty-to-defend provision. An endorsement to the policy extended coverage to employees acting within the scope of their duties. The indemnity provision provided coverage for damages because of bodily injury caused by an occurrence. The term "occurrence" was not defined in the policy itself, only in the policy jacket.⁸⁸

St. Paul entered a defense for Sun Life but refused to defend Pryseski.⁸⁹ St. Paul eventually settled the Grantland tort ac-

ing, "[t]he courts have generally placed the burden of uncertainty as to the policy's coverage on the insurer.").

84. 1A R. LONG & M. RHODES, *supra* note 67, § 5.01; see also *infra* notes 232-256 and accompanying text.

85. 292 Md. 187, 438 A.2d 282 (1981).

86. The complaint contained three counts. The first, for intentional infliction of emotional distress, alleged that Pryseski, during the course of and while acting in the scope of his employment with Sun Life, made sexual advances toward Mrs. Grantland. The second count, for assault and battery, asserted that Pryseski, during the course of and while in the scope of his employment with Sun Life, assaulted and battered Mrs. Grantland. The third count was a joint claim by Mr. and Mrs. Grantland for loss of consortium. Pryseski's duties at Sun Life included the collecting of insurance premiums. *Id.* at 190-91, 438 A.2d at 284.

87. Personal injury liability insurance provides coverage for such offenses as false arrest, malicious prosecution, defamation, and wrongful entry or eviction.

88. *Pryseski*, 292 Md. at 189, 438 A.2d at 283. In its appellant's brief, however, St. Paul indicated that the term "occurrence" was defined in a policy jacket that for some reason had not been attached to Pryseski's petition for a declaratory judgment, nor had it been produced by St. Paul with the rest of the policy during discovery or introduced by either Pryseski or St. Paul into evidence at trial. Because the jacket was not part of the record in the case, the court of appeals remanded and instructed that the definition of "occurrence" in the jacket could be considered by the trial court. *Id.* at 199-200, 438 A.2d at 288-89.

89. St. Paul refused to defend Pryseski on two grounds: (1) Pryseski was not acting

tion,⁹⁰ but Pryseski filed suit for a declaratory judgment that St. Paul had a duty to defend him because of a "potentiality" of coverage, and sought recovery of the legal expenses he incurred as a result of St. Paul's breach of its duty.⁹¹ The trial court ruled that St. Paul had a duty to defend Pryseski. St. Paul appealed, and the court of special appeals affirmed on the basis of *Brohawn*.⁹² The court of appeals granted *certiorari*.⁹³

In considering the coverage issue, the court of appeals established a comparison test:

In determining whether a liability insurer has a duty to provide its insured with a defense in a tort suit, two types of questions ordinarily must be answered: (1) what is the coverage and what are the defenses under the terms and requirements of the insurance policy? (2) do the allegations in the tort action potentially bring the tort claim within the policy's coverage? The first question focuses upon the language and requirements of the policy, and the second question focuses upon the allegations of the tort suit. At times these two questions involve separate and distinct matters, and at other times they are intertwined, perhaps involving an identical issue.⁹⁴

The court then qualified its comparison test by placing the *Brohawn* potentiality rule within the framework of the test:

The 'rule' . . . that the insurer has a duty to defend if the allegations of the tort suit raise a 'potentiality' that coverage exists, is generally applicable only to the second question set forth above. It may, however, be applicable to an issue raised under the first question set forth above if that issue must also be resolved in the underlying tort suit.⁹⁵

After establishing the comparison test, the court of appeals attempted to apply it to the facts of the dispute between Pryseski and St. Paul. Under the first inquiry, the court found that the policy obligated St. Paul to indemnify Sun Life for all sums that Sun Life was legally bound to pay as damages caused by an "occurrence" committed by an employee acting within the scope of his employment. Owing to procedural oversight, however, the trial court had not considered the definition of occurrence given in the policy jacket.⁹⁶ Therefore, the case was remanded for further consideration and the court never reached the sec-

within the scope of his employment; and (2) the policy excluded coverage for "willful acts in violation of [a] penal statute or ordinance." *Id.* at 191, 438 A.2d at 284.

90. St. Paul obtained a release from the Grantlands for both Pryseski and Sun Life. *Id.* 91. *Id.*

92. The court of special appeals' opinion was unreported. See *St. Paul Fire & Marine Ins. Co. v. Pryseski*, 47 Md. App. 753 (decided Oct. 27, 1980).

93. 289 Md. 741 (*cert. granted* Feb. 10, 1981).

94. *Pryseski*, 292 Md. at 193-94, 438 A.2d at 285.

95. *Id.*

96. See *supra* note 88.

ond prong of the test.⁹⁷

Although the court of appeals in *Pryseski* never completed its application of the comparison test, it noted that the complaint raised a potentiality of coverage when it alleged that Pryseski was acting within the scope of his employment when he sexually assaulted Mrs. Grantland.⁹⁸ This conclusion, however, would not have ended the inquiry. St. Paul would have had a duty to defend *only if* the Grantlands' claims were of the type that fell within the definition of occurrence. If the allegations against Pryseski did not actually or potentially amount to an occurrence as defined in the insurance policy, St. Paul would not have been obligated to defend Pryseski.⁹⁹

The *Pryseski* comparison test seeks to establish a reliable and mechanical method for determining both actual and potential coverage. It also seeks to differentiate between coverage issues that are "separate and distinct" from the issues in the tort suit and those that are "intertwined" with the issues in the tort suit. Intertwined coverage questions are those that cannot be tried in a separate declaratory action if the underlying tort action is pending because they involve an ultimate issue at trial.¹⁰⁰ A factual issue is intertwined with the underlying tort action if it is "squarely presented for resolution in the tort action . . .,"¹⁰¹ is material to establishing the tort liability of the insured, and would establish the insurer's liability under its duty to indemnify.¹⁰² A factual issue is *not* material if it is collateral to the issues in the underlying tort action but would nevertheless bear upon the insurer's liability under its duty to indemnify.¹⁰³

97. *Pryseski*, 292 Md. at 199-200 & n.1, 438 A.2d at 288-89 & n.1.

98. *Id.* at 196, 438 A.2d at 287 ("In light of the allegations of the tort suit concerning scope of employment and ratification, the court of special appeals in this case correctly held that the tort suit determined the scope of employment issue.").

99. *See* Edward Winkler & Son, Inc. v. Ohio Casualty Ins. Co., 51 Md. App. 190, 441 A.2d 1129 (1982).

100. Whether Brohawn acted intentionally or negligently, or whether Pryseski was acting within the scope of his employment, are prime examples of this type of coverage question.

101. *Maryland Auto. Ins. Fund v. Sun Cab Co.*, 305 Md. 807, 810, 506 A.2d 641, 643 (1986); *see also* *Pope v. Sun Cab Co.*, 62 Md. App. 218, 225, 488 A.2d 1009, 1012 (1984) (the *Brohawn* court's concept of "ultimate issues" includes "those issues raised by a [party] which, if resolved in his favor, will provide him with an absolute defense to the pending suit"), *aff'd sub nom.* *Maryland Auto Ins. Fund v. Sun Cab Co.*, 305 Md. 807, 506 A.2d 641 (1986).

102. *Compare* *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 317, 475 A.2d 509, 514-15 (issue must be material to tort action), *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984) *with* *Travelers Indem. Co. v. Insurance Co. of N. Am.*, 69 Md. App. 664, 671, 519 A.2d 760, 763 (1987) (issue must be central to tort action).

103. For example, the question whether a driver of an automobile is using it with the permission of the owner is collateral to the driver's tort liability but would have had a bearing on the insurer's duty to indemnify. In most cases, a factual question that is *collateral* to the issues in the underlying tort action does not create a conflict of interest over the conduct of the defense, and the insurer would not have to offer the insured his *Brohawn* choice of counsel. *See infra* notes 181-182 and accompanying text. There is even authority that an insurer can move beyond the four corners of

Unfortunately, the *Pryseski* court's statement that the first and second prongs of the test may be intertwined or even involve the identical issue has created abundant confusion. The court's qualification that the potentiality rule is generally applicable only to the second part of the comparison test, but may, under some circumstances, be applicable to the first part, has only compounded the problem.

The *Pryseski* comparison test is little more than a recognition that before a court can address whether there is a "potentiality of coverage," it must first ascertain the scope of "coverage" under the policy's language.¹⁰⁴ Under the first step, the court tries to determine "what sorts of claims are covered under the policy"¹⁰⁵ by applying the principles of construction¹⁰⁶ to the policy's coverage grants, definitions and exclusions. If the policy is unambiguous, the court determines its scope as a matter of law.¹⁰⁷ If the policy is ambiguous, the court may consider extrinsic evidence in an attempt to resolve the ambiguity.¹⁰⁸ If the extrinsic evidence is inconclusive, the policy is construed against the insurer.¹⁰⁹

the claimant's pleadings to consider the actual, rather than the alleged, facts in determining whether it has a duty to defend. See *Rairigh*, 59 App. at 320-21, 475 A.2d at 516-17; see also notes 257-275 and accompanying text.

104. The first step is to consider the definitions of the key terms in the coverage grant in order to ascertain the breadth of the insurer's duty to indemnify. The key terms in the standard duty-to-defend provision are "damages," "property damage," "bodily injury," "caused by" and "occurrence." See Sharpe & Shaffer, *supra* note 1, at 557-61. Usually, each of these terms is defined in the policy, and Maryland courts have considered many of the standard definitions. The exclusions are then considered to determine how the policy narrows the scope of its coverage. Both coverage grants and coverage exclusions are interpreted in the same manner. Maryland, unlike other jurisdictions, does not read exclusions more narrowly than coverage grants. See *Northern Assurance Co. of Am. v. EDP Floors, Inc.*, 311 Md. 217, 227, 533 A.2d 682, 687 (1987). Exclusions are independent of each other and are read separately against the coverage grant. See *Century I Joint Venture v. United States Fidelity & Guar. Co.*, 63 Md. App. 545, 559, 493 A.2d 370, 377-78, *cert. denied*, 304 Md. 297, 498 A.2d 1183 (1985).
105. *Southern Md. Agric. Ass'n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295 (D. Md. 1982).
106. Construction of an insurance policy is governed by "a few well-established principles." *Pacific Indem. Co. v. Interstate Fire & Casualty Co.*, 302 Md. 383, 388, 488 A.2d 486, 488 (1985). One principle is to apply the contract's terms unless they violate a statute, a regulation, or public policy. *Mutual Fire, Marine & Inland Ins. Co. v. Vollmer*, 306 Md. 243, 250, 508 A.2d 130, 133 (1986). A second principle is to construe the instrument as a whole to determine the intention of the parties to the insurance contract. *Pacific Indem.*, 302 Md. at 388, 488 A.2d at 488; see also *Aragona v. St. Paul Fire & Marine Ins. Co.*, 281 Md. 371, 375, 378 A.2d 1346, 1348 (1977); *Federal Ins. Co. v. Allstate Ins. Co.*, 275 Md. 460, 473, 341 A.2d 399, 407 (1975). Finally, "the character of the contract, its purpose, and the facts and circumstances of the parties at the time of execution" should be examined. *Pacific Indem.*, 302 Md. at 388, 488 A.2d at 488; see also *Allstate Ins. Co. v. Humphrey*, 246 Md. 492, 496, 229 A.2d 70, 72 (1967).
107. *Pacific Indem.*, 302 Md. at 389, 488 A.2d at 489; *Aragona*, 281 Md. at 375, 378 A.2d at 1348.
108. See *Pryseski*, 292 Md. at 194, 438 A.2d at 288; *Pacific Indem.*, 302 Md. at 389, 488 A.2d at 489.
109. See *Southern Md. Agric. Ass'n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295,

Once the scope of the coverage is determined, the court moves to the second step to decide if the allegations in the claimant's pleadings fall actually or potentially within the scope of the policy's coverage. This is done by comparing the allegations in the complaint to the scope of coverage to determine if the complaint alleges a claim that is the type of claim covered under the policy. If the court cannot resolve the question because the insurer's duty to indemnify depends on a factual issue that will be resolved in the underlying tort suit (such as whether Brohawn acted intentionally or negligently, or whether Pryseski was acting within the scope of his employment), the court applies the *Brohawn* potentiality rule and requires the insurer to defend. The insurer is then obligated to defend the suit until such time, if ever, that the only claims remaining are ones outside the policy coverage.¹¹⁰ Accordingly, the duty to defend is a continuing obligation that springs into being when a claim comes actually or potentially within the policy's coverage and ceases only when facts show that all potentiality of coverage has been eliminated.¹¹¹ Even then, an insurer that has begun a defense may have to complete it if its withdrawal would prejudice the insured.¹¹²

It is perhaps doubtful whether the two parts of the comparison test can be intertwined, much less whether they involve the identical issue. Conceptually, the test always involves two separate inquiries, even if the court decides to frame the inquiries into one question.¹¹³ The *Pryseski* court's statement that the first and second inquiries of the comparison test may be intertwined or involve the identical issue, then, merely reflects the fact that the court cannot determine on the basis of the pleadings whether the insurer has a duty to *indemnify* where factual issues must be resolved in the underlying tort action. Viewing the two parts as intertwined confuses the test for determining the insurer's duty to defend with the test for determining the insurer's liability under its duty to in-

1299 (D. Md. 1982); *Pryseski*, 292 Md. at 194, 438 A.2d at 288; *Truck Ins. Exch. v. Marks Rentals, Inc.*, 288 Md. 428, 435, 418 A.2d 1187, 1191 (1980). Construing the policy against the insurer and in favor of the insured does not automatically result in coverage; all it does is resolve the ambiguity in favor of the insured. The court must still move to the second inquiry to determine if the allegations fall actually or potentially within the coverage *as construed*.

110. *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 407-09, 347 A.2d 842, 850 (1975); see also *Steyer v. Westvaco Corp.*, 450 F. Supp. 384 (D. Md. 1984).

111. 1A R. LONG & M. RHODES, *supra* note 67, § 5.01.

112. See generally *id.* A prudent insurer generally will not withdraw unilaterally from a defense but will file a declaratory judgment action to have a court declare that the defense duty has ceased.

113. For example, in *Edward Winkler & Son v. Ohio Casualty Ins. Co.*, 51 Md. App. 190, 441 A.2d 1129 (1982), the court of special appeals observed that where determination of liability required both interpretation of the policy term "accident" and an analysis of the tort action to see if it could potentially be regarded as an accident, the two issues were "intertwined." *Id.* at 194, 441 A.2d at 1131-32. Nevertheless, the court determined the definition of "accident" before finding that the allegations against the insured did not describe an "accident" within the meaning of the policy. *Id.* at 195-96, 441 A.2d at 1132.

demnify.¹¹⁴ The scope of the insurer's duty to indemnify (what the policy covers), however, can be determined in the first prong of the comparison test. Once the scope of the insurer's duty to indemnify is ascertained, the allegations of the claimant's pleadings can then be analyzed to see if they fall within the policy's coverage.

The court of appeals' qualification in *Pryseski* that the potentiality rule may be applicable to the *first* prong of the comparison test has compounded the confusion over the concept of "potentiality of coverage." Consequently, inventive attorneys have tried to extend an insurer's liability beyond the scope of the policy's coverage by applying the potentiality test to the court's interpretation of the policy itself.¹¹⁵ In *Northern Assurance Co. of America v. EDP Floors, Inc.*,¹¹⁶ however, the court of appeals specifically rejected the application of the potentiality rule to the first prong of the comparison test. The court stated that applying the potentiality rule to the question of the scope of the insurer's duty to indemnify "would in effect create a canon of insurance contract interpretation that gives every benefit of the doubt to the insured, in contravention of [the] many holdings that the unambiguous language in an insurance contract is to be afforded its ordinary and accepted meaning."¹¹⁷

The *Pryseski* comparison test, then, is best seen as a two step process in which the court first determines the scope of the coverage and then determines whether the pleadings set forth a claim that falls within that scope. The first step focuses on the policy and involves the rules of construction. The second step focuses on the allegations in the claimant's pleadings and may involve the application of the potentiality rule. The test is not whether the policy can be construed to raise a potential duty to defend, but whether the allegations raise a potential duty to indemnify. The distinction is significant, but too often insureds and insurers try to convert the potentiality rule into a rule of contract construction.¹¹⁸

114. For a more detailed analysis of the interplay between the comparison test and an intertwined coverage question, see *Southern Md. Agric. Ass'n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295 (D. Md. 1982).

115. See, e.g., *Pederson v. Republic Ins. Co.*, 72 Md. App. 661, 532 A.2d 183 (1987). In *Pederson*, the policyholder argued that because the scope of the coverage of their homeowner's policy was unclear, "there was, at least, a *potentiality* of coverage." *Id.* at 665, 532 A.2d at 185 (emphasis in original).

116. 311 Md. 217, 533 A.2d 682 (1987).

117. *Id.* at 226, 533 A.2d at 686.

118. It is apparent that in practice, an insurer is often uncertain about the scope of its duty to indemnify, and defends not because it believes that the allegations may give rise to a duty to defend but because it fears that its policy could be interpreted to broaden the scope of its duty to indemnify.

IV. THE CONSEQUENCES OF AN INSURER'S WRONGFUL REFUSAL TO DEFEND

A. *Liability for Contract Damages*

An insurer that breaches its duty to defend¹¹⁹ is liable for the contract damages incurred by the insured.¹²⁰ Contract damages are those that arise naturally from the breach and that were reasonably within the contemplation of the parties at the time they entered into the contract.¹²¹ They usually consist of legal expenses and fees incurred by the insured in defending the underlying tort action, or in bringing or defending a declaratory judgment action¹²² to determine the coverage issue.¹²³

Under the Maryland Uniform Declaratory Judgments Act, either the insurer or the insured may have the court determine any question of coverage under a policy.¹²⁴ A declaratory judgment action is an appro-

119. It is axiomatic that if "the insurer's refusal to defend was not wrongful, it is not liable for attorneys' fees." *Northern Assurance*, 311 Md. at 232, 533 A.2d at 690.

120. The right to recover for breach of a duty to defend applies to the named insured and to "any person who is within the policy definition of an insured against whom a claim alleging a loss within the policy coverage has been filed." *Bankers & Shippers Ins. Co. v. Electro Enter., Inc.*, 287 Md. 641, 649, 415 A.2d 278, 283 (1980). The right does not extend to all successful *parties* in the declaratory judgment action, only to successful *insureds*. *Id.* at 649-50, 415 A.2d at 283.

121. *Pennsylvania Threshermen & Farmers' Mut. Casualty Ins. Co. v. Messenger*, 181 Md. 295, 300-01, 29 A.2d 653, 656 (1943). Punitive damages would not be allowed. *See H. & R. Block, Inc. v. Testerman*, 275 Md. 36, 44-46, 338 A.2d 48, 53 (1974) (punitive damages cannot be awarded in pure breach of contract actions but are recoverable in torts arising out of a contract if actual malice is shown).

122. *See Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 475 A.2d 509, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984) (successful insured entitled to costs and expenses of appeal from declaratory judgment action). *Compare Cohen v. American Home Assurance Co.*, 255 Md. 334, 350-63, 258 A.2d 225, 234-39 (1969) (expenses incurred in bringing declaratory judgment action) *with Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 409-10, 347 A.2d 842, 851 (1975) (expenses incurred in defending declaratory judgment action awarded to insured).

123. *American Home Assurance Co. v. Osbourn*, 47 Md. App. 73, 84, 422 A.2d 8, 14-15 (1980), *cert. denied*, 289 Md. 739 (1981). Attorney's fees are ordinarily not awarded in a declaratory judgment action. *Maryland Auto Ins. Fund v. Sparks*, 42 Md. App. 382, 395, 400 A.2d 26 (1979). Awarding an insured attorney's fees and litigation costs when an insurer unjustifiably refuses to defend is an exception to this general rule. *See Osbourn*, 47 Md. App. at 84, 422 A.2d at 14. This exception is "well established." *See Continental Casualty Co. v. Board of Educ.*, 302 Md. 516, 538, 489 A.2d 536, 547 (1985).

124. *World Ins. Co. v. Perry*, 210 Md. 449, 452, 124 A.2d 259, 260 (1956). The act provides that:

[A]ny person interested under a . . . written contract, or other writing constituting a contract, or whose rights, status, or other legal relations are affected by a . . . contract . . . may have determined any question of construction or validity arising under the . . . contract . . . and obtain a declaration of rights, status, or other legal relations under it.

MD. CTS. & JUD. PROC. CODE ANN. § 3-406 (1984). A declaratory judgment may be sought "notwithstanding the availability of concurrent common law, equitable, or extra-ordinary forms of relief." *Century I Joint Venture v. United States Fidelity & Guar. Co.*, 63 Md. App. 545, 560-61, 493 A.2d 370, 378, *cert. denied*, 304 Md. 297, 484 A.2d 1183 (1985).

priate and useful means of resolving policy coverage questions when they are "independent and separable" from the claims asserted in the underlying tort action.¹²⁵ Early resolution of these coverage questions may avoid unnecessary expense and delay to both insurer and insured,¹²⁶ and an insurer would be wise to pursue declaratory relief in most cases where it is available.

"Independent and separable" coverage questions might include the enforceability of the policy itself (e.g., whether the insured has paid his premiums); technical policy defenses (e.g., whether the insured has breached or fulfilled his duties of notification and cooperation); construction questions (e.g., the definition of the term "occurrence" in *Pryseski*); and factual questions involving issues that are not material to the underlying tort action (e.g., whether the driver of a vehicle was driving an automobile covered by the insurance policy).¹²⁷ These questions have nothing to do with the factual issues in the underlying tort action and can be tried in a separate declaratory action before, or after the underlying tort action.¹²⁸ Moreover, the insurer, in order to save defense costs, can move to stay the underlying tort action pending a resolution of the declaratory judgment action. A trial court has the discretion to refuse to grant a declaratory judgment,¹²⁹ and should do so when the declaratory judgment action seeks to resolve "intertwined" coverage questions.¹³⁰

The award of attorney's fees and litigation expenses incurred in a declaratory judgment action is justified on two grounds.¹³¹ First, the in-

125. *Brohawn*, 276 Md. at 405, 347 A.2d at 849.

126. *Id.*

127. If the insurer believes that it has a legitimate policy defense, it should nevertheless defend the insured under a reservation of rights, while at the same time filing a declaratory judgment action to determine whether the policy defense is valid. See *infra* notes 249-256 and accompanying text.

128. As a precaution, if the insurer believes that its policy does not cover the type of claim asserted in the claimant's pleadings, it should defend under a reservation of rights and seek declaratory relief defining the scope of its obligations. See *infra* notes 249-256 and accompanying text.

129. The declaratory judgment process should not be used if a declaration of rights would not serve a useful purpose or terminate the existing controversy. MD. CTS. & JUD. PROC. CODE ANN. § 3-409(a) (1984); accord *Century I Joint Venture v. United States Fidelity & Guar. Co.*, 63 Md. App. 545, 561, 493 A.2d 370, 379, cert. denied, 304 Md. 297, 484 A.2d 1183 (1985); see also *Brohawn*, 276 Md. at 406, 347 A.2d at 849 ("If the granting of the [declaratory] judgment would unduly inconvenience or burden the parties, or allow one party to wrest control of the litigation from another and cause a confusing alteration of the burden of proof, the court should refuse to grant the [declaratory] relief. . .").

130. *Brohawn*, 276 Md. at 405-06, 347 A.2d at 849; see also *Haynie v. Gold Bond Bldg. Prods.*, 306 Md. 644, 652, 511 A.2d 40, 44 (1986) (The rule that a court should decline to decide an issue that is pending in another action is neither jurisdictional nor absolute. It is discretionary, and "[a] declaratory judgment may be rendered to decide an issue, even though the issue is presented in another pending case between the parties in 'very unusual and compelling circumstances.'") (quoting *A.S. Abell Co. v. Sweeney*, 274 Md. 715, 721, 337 A.2d 77, 81 (1975)); *Harpy v. Nationwide Mut. Fire Ins. Co.*, 76 Md. App. 474, 545 A.2d 718 (1988).

131. See *Cohen v. American Home Assurance Co.*, 255 Md. 334, 350-63, 258 A.2d 225,

surer is said to have "authorized" the expenditure of the fees by its failure to defend. Second, the fees are considered part of the damages sustained by the insured as a result of the insurer's breach of its contractual duty to defend.¹³² The insured has the burden of proving the expenses and fees "with the certainty and under the standards ordinarily applicable for proof of contractual damages."¹³³

A judgment entered against or an amount paid pursuant to a settlement entered into by an insured following his insurer's breach of its duty to defend is not necessarily part of the contract damages. The duty to defend and the duty to indemnify are independent and distinct obligations. While the duty to defend arises because of *alleged* facts, the duty to indemnify arises because of *actual* facts. It is not uncommon for an insurer to have a duty to defend but no duty to indemnify. A judgment entered against an insured determines his tort liability but does not necessarily determine the insurer's liability under its duty to indemnify. Similarly, a settlement between the claimant and the insured extinguishes the insured's tort liability but does not establish insurance coverage.¹³⁴ There is no causal nexus between the insurer's breach and the resulting judgment.¹³⁵ Therefore, an insurer that has breached its duty to defend can ordinarily deny it has an obligation to pay a final judgment.

Under some circumstances, however, the insurer may be collaterally estopped from relitigating an issue that has been decided in the underlying tort action.¹³⁶ Collateral estoppel precludes relitigation whenever the

234-39 (1969). The court of appeals has admitted that the recovery of litigation expenses and attorneys' fees incurred by an insured in bringing or defending a declaratory judgment action is based on an "unrefined" legal theory. See *Continental Casualty Co. v. Board of Educ.*, 302 Md. 516, 537, 489 A.2d 536, 547 (1985).

132. *American Home Assurance Co. v. Osbourn*, 47 Md. App. 73, 84, 422 A.2d 8, 14-15 (1980), *cert. denied*, 289 Md. 739 (1981).

133. *Bankers & Shippers Ins. Co. v. Electro Enter. Inc.*, 287 Md. 641, 661, 415 A.2d 278, 289 (1980); *Travelers Indem. Co. v. Insurance Co. of N. Am.*, 69 Md. App. 664, 681, 519 A.2d 760, 768 (1987) (quoting *Bankers & Shippers*, 287 Md. at 661, 415 A.2d at 289); see also *Continental*, 302 Md. at 538, 489 A.2d at 547.

134. In *McCarthy v. United Serv. Auto. Ass'n*, 24 Misc. 2d 79, 204 N.Y.S.2d 420 (N.Y. Sup. Ct. 1960), the court distinguished between tort liability and insurance coverage:

The fact that [the insurer] may have had an obligation to defend . . . or that he violated such obligation may render him liable in damages . . . had [the insured] expended money to defend himself. It does not by itself render [the insurer] liable for the judgment. There is a distinction between liability and coverage.

Id. at 80, 204 N.Y.S.2d at 421; accord *Hargis v. Maryland Am. Gen. Ins. Co.*, 567 S.W.2d 923, 928 (Tex. Ct. App. 1978) (cited by *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 322, 475 A.2d 509, 517, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984)).

135. See Comment, *The Insurer's Duty*, *supra* note 6, at 740.

136. *Id.* In *Farmers Ins. Co. v. Vagnozzi*, 138 Ariz. 443, 675 P.2d 703 (1983) (cited by *Rairigh*, 59 Md. App. at 322, 475 A.2d at 517), the court admitted that there is "interplay and confusion of the doctrine of collateral estoppel and the insurer's duty under the insurance policy to defend an insured." *Id.* at 445, 675 P.2d at 705. In Maryland, there is additional confusion about the difference between the doctrines

issues in the two suits are identical.¹³⁷ In general, the insurer "is bound under the doctrine of collateral estoppel by the facts determined in the trial of such action which are essential to the judgment of tort liability."¹³⁸ Thus, the insurer would not be able to relitigate the tort liability of the insured, nor could it contest the amount of the judgment against the insured or the legal and factual basis for that judgment.¹³⁹ Moreover, if the underlying tort action determined an "intertwined" coverage issue, such as whether an insured acted intentionally or negligently, or whether an employee of the insured was acting within the scope of his employment, then the insurer would be precluded from relitigating that issue.¹⁴⁰ If, however, the insurer's duty to indemnify rested on a factual issue that was not material to the tort liability in the underlying tort action, then the insurer would be able to relitigate that issue, even if the issue had been decided by the fact finder in the underlying tort action.¹⁴¹

of equitable estoppel and collateral estoppel. In *Rairigh*, for instance, the court lumps a discussion of the two doctrines under the heading of "estoppel," even though they are separate and independent. *Rairigh*, 59 Md. App. at 315, 475 A.2d at 514.

137. Collateral estoppel provides that only those issues which were "actually litigated" in the prior suit are conclusive against the same parties litigating the same issues in a subsequent proceeding. *MacKall v. Zayre Corp.*, 293 Md. 221, 228, 443 A.2d 98, 101-02 (1982). The application of collateral estoppel between the insurer and the insured is predicated upon an assumed identity of interest of the parties to the insurance policy in opposing the claimant's tort action. *Rairigh*, 59 Md. App. at 316, 475 A.2d at 514. One commentator contends, however, that collateral estoppel is not applicable, and that the insurer would always be able to relitigate the coverage issue, even if the underlying tort action had decided what he terms "common issues" (i.e., "intertwined" factual issues). Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 3 UTAH L. REV. 457, 490-91 (1981). The Maryland courts have taken a contrary position, holding that an insurer is precluded from relitigating factual issues that were material to the underlying tort action and that were actually decided in the underlying tort action. See *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 409-10, 347 A.2d 842, 851 (1975); *Allstate Ins. Co. v. Atwood*, 71 Md. App. 107, 523 A.2d 1066, cert. granted, 310 Md. 274, 528 A.2d 1286 (1987). The Maryland approach is logical when the factual issue in the underlying tort action is identical to the factual issue that determines coverage, and the justification for this preclusion is even stronger where the insurer has intervened in the underlying tort action. For a discussion of the insurer's right of intervention, see *Atwood*, 71 Md. App. at 113, 523 A.2d at 1069.
138. *Vagnozzi*, 138 Ariz. at 445, 675 P.2d at 705. See generally A. WINDT, *supra* note 71, § 6.23, at 339 (Insurer is bound "by the resolution of all issues that necessarily had to be resolved in adjudicating the underlying [tort] action.").
139. See Comment, *The Insurer's Duty*, *supra* note 6, at 741.
140. See *Brohawn*, 276 Md. at 409-10, 347 A.2d at 851-52; *Atwood*, 71 Md. App. at 112, 523 A.2d at 1069.
141. See, e.g., *Vagnozzi*, 138 Ariz. at 445, 675 P.2d at 705 ("A party will not be precluded from litigating policy coverage in a subsequent proceeding if the question of coverage turns on facts which are nonessential to the judgment of tort liability."). In *Hargis v. Maryland Am. Gen. Ins. Co.*, 567 S.W.2d 923 (Tex. Civ. App. 1978) (cited by *Rairigh*, 59 Md. App. at 322, 475 A.2d at 517), the court stated that collateral estoppel "extends only to points directly involved in the action decided, and not to any matter which was only incidentally cognizable, or which came collaterally in question." This is true, even though the matter coming collaterally in question may have been judicially passed on." *Id.* at 928 (quoting *Berger v. Kirby*, 135

In approaching the issue of whether an insurer is precluded from relitigating an issue that was adjudicated in, but was not material to, the underlying tort action, the court must consider competing interests. On one side, there is concern for "judicial economy, finality of decisions, and avoidance of conflicting judgments."¹⁴² There is also the desire to "forestall round robin litigation of issues" among the claimant, the insured and the insurer.¹⁴³ On the other side is the insurer's due process right to have its day in court. This fundamental right "may override any considerations of efficiency or expediency served by the minimization of litigation."¹⁴⁴ Thus, "[e]lementary fairness demands a proceeding in which the differences between the insurer and insured may be tried."¹⁴⁵

Although an insurer that breaches its duty to defend relinquishes control of the litigation and settlement process,¹⁴⁶ it is nevertheless obligated only for any amounts the insured paid in settling a claim that is *actually*, not just *potentially*, covered by the policy.¹⁴⁷ The settlement, however, must be reasonable and must have been made in good faith and with due care.¹⁴⁸ The basis for holding the insurer liable for the insured's reasonable, good faith settlement of a covered claim rests on the terms of the standard policy that obligate the insurer to pay on behalf of the insured any amount which the insured has become *legally obligated* to pay.¹⁴⁹ The settlement is seen as part of the insured's damages.

S.W. 1122 (Tex. Civ. App. 1911), *aff'd*, 153 S.W. 1130 (Tex. 1913)); *see also* Glens Falls Ins. Co. v. American Oil Co., 254 Md. 120, 254 A.2d 658 (1969) (issue of whether the insured intentionally ran his automobile into the claimant was not presented for resolution in the underlying tort action because the claimant sued only on a negligence theory). For an explanation of *Glens Falls*, *see Brohawn*, 276 Md. at 414 n.3, 347 A.2d at 853-54 n.3.

142. Allstate Ins. Co. v. Atwood, 71 Md. App. 107, 523 A.2d 1066, *cert. granted*, 310 Md. 274, 528 A.2d 1286 (1987).

143. Steyer v. Westvaco Corp., 450 F. Supp. 384, 397 (D. Md. 1978).

144. *Glens Falls*, 254 Md. at 134, 254 A.2d at 666.

145. *Rairigh*, 59 Md. App. at 321, 475 A.2d at 517. There is even authority for the proposition that the doctrine of collateral estoppel is suspended whenever there exists a conflict of interest over the defense of the underlying tort action. *See Hargis*, 567 S.W.2d at 928; *cf.* RESTATEMENT (SECOND) JUDGMENTS, §§ 57(2), 58 (1982). Maryland evidently does not follow this proposition, because it requires the insurer to defend despite the conflict of interest and also allows the insurer to intervene in the underlying tort action to protect its interests. *See infra* notes 175-205 and accompanying text.

146. *See* United States Fidelity & Guar. Co. v. National Paving & Contracting Co., 228 Md. 40, 48, 178 A.2d 872, 875 (1962) ("It is settled law that where there is a denial of liability and a refusal to defend on the part of the insurer . . . the insured is no longer bound by a provision of a policy prohibiting settlement of claims without the insurer's consent, or a provision making the insurer's liability dependent on the obtaining of a judgment against the insured."). *See generally* Comment, *The Insurer's Duty*, *supra* note 6, at 743.

147. *National Paving*, 228 Md. at 48, 178 A.2d at 875; *Oweiss v. Erie Ins. Exch. Co.*, 67 Md. App. 712, 720, 509 A.2d 711, 715-16 (1986).

148. *National Paving*, 228 Md. at 48, 178 A.2d at 875.

149. *See Theodore v. Zurich Gen. Accident & Liab. Ins. Co.*, 364 P.2d 51 (Alaska 1961). In *Theodore*, the court noted that insurer's liability for settlement of a claim within coverage follows from its failure to defend because "that which is paid in a prudent

The settlement of a claim that is outside the policy's coverage, in contrast, is not a natural consequence of the insurer's failure to defend and will not obligate the insurer to indemnify the insured, even if the settlement was reasonable and made in good faith.¹⁵⁰ When an insured settles both covered and non-covered claims, the insurer is liable for the amount of the settlement attributable to covered claims. Maryland has not decided whether the insurer or the insured should bear the burden of persuading the fact-finder that part or all of the settlement was for covered claims, but it would appear that in order to foster prudent settlements of tort actions and discourage insurers from wrongfully disclaiming coverage, the insurer should bear that burden.¹⁵¹

B. No Creation of Coverage by Waiver or Equitable Estoppel

The duty to indemnify may not be predicated upon a breach of the insurer's duty to defend.¹⁵² Thus, an insurer that breaches its duty to defend is not precluded by either waiver¹⁵³ or equitable estoppel¹⁵⁴ from later raising a defense to its duty to indemnify. Although waiver or equitable estoppel may prevent an insurer from asserting technical policy defenses, they may not be used by the insured to expand the policy to create coverage that the insurer did not agree to undertake.¹⁵⁵ Therefore, the

settlement of an action for damages is something which the insured has 'become legally obligated to pay' within the meaning of the insurance policy." *Id.* at 55-56.

150. See *Harford Mut. Ins. Co. v. Jacobson*, 73 Md. App. 670, 684, 536 A.2d 120, 127, cert. denied, 312 Md. 601, 541 A.2d 964 (1988); *Travelers Indem. Co. v. Insurance Co. of N. Am.*, 69 Md. App. 664, 519 A.2d 760 (1987); *Oweiss*, 67 Md. App. at 720-21, 509 A.2d 715-16; see also *Western World Ins. v. Harford Mut. Ins. Co.*, 784 F.2d 558 (4th Cir. 1986).

151. Comment, *The Insurer's Duty*, *supra* note 6, at 744 (to balance the policy that an insurer should not be liable for risks not paid for by the insured against the policy that settlements of lawsuits should be encouraged, the insurer should bear the burden of proving that all or part of insured's settlement was made on grounds outside of coverage); see also A. WINDT, *supra* note 71, § 4.13, at 162-63.

152. *Kelly v. Cherokee Ins. Co.*, 574 S.W.2d 735, 739 (Tenn. 1978).

153. Waiver is a "voluntary and intentional relinquishment of a known right." *Progressive Casualty Ins. Co. v. Ehrhardt*, 69 Md. App. 431, 443, 518 A.2d 151, 157 (1986). In order for a waiver to exist, the "acts relied upon . . . must be inconsistent with an intention to insist upon enforcing . . ." the party's contractual rights. *Rubenstein v. Jefferson Nat'l Life Ins. Co.*, 268 Md. 388, 392-93, 302 A.2d 49, 52 (1973) (quoting *Food Fair v. Blumberg*, 234 Md. 521, 531, 200 A.2d 166, 172 (1964)).

154. "Waiver is closely inter-related and intertwined with estoppel." *Gould v. Transamerican Assoc.*, 224 Md. 285, 295, 167 A.2d 905, 909 (1961). Estoppel is an equitable doctrine that prevents a party from asserting a right because the party has conducted himself in such a manner that it would be contrary to equity and good conscience to let him assert the right. *Wright v. Wagner*, 182 Md. 483, 492, 34 A.2d 441, 446 (1943). While the two terms are often used synonymously, they are separate and distinct doctrines. For a discussion of the elements of waiver and estoppel, see *Benson v. Borden*, 174 Md. 202, 219-20, 198 A. 419, 427-28 (1938).

155. *Traveler's Ins. Co. v. Godsey*, 260 Md. 669, 675, 273 A.2d 431, 435 (1971); *Insurance Co. of N. Am. v. Coffman*, 52 Md. App. 732, 742-43, 451 A.2d 952, 957 (1982). It is theoretically possible for the doctrine of equitable estoppel to expand coverage under certain circumstances. The insured, however, must show detrimental reliance and, as the Fourth Circuit noted in *Western World Ins. Co. v. Harford*

insurer will be able to assert that it had no duty to indemnify despite a breach of its duty to defend.¹⁵⁶

The rationale for prohibiting an insured from asserting waiver or equitable estoppel is sound. The duty to defend is broader than the duty to indemnify, and an insurer may have a duty to defend but no duty to indemnify.¹⁵⁷ An insurer that breaches its contractual duty to defend should not be punished by imposing on it the additional burden of an expanded duty of indemnification. As one commentator has stated, "[t]he insurer's breach of contract should not . . . be used as a method of obtaining coverage for the insured that the insured did not purchase."¹⁵⁸ If the insurer owed a duty to defend but no duty to indemnify, then the insured would receive the benefit of the bargain through an award of defense costs. The judgment would have been the insured's responsibility even if the insurer had defended.¹⁵⁹

C. *Defending Insurer's Right to Recover Costs from Co-Insurer That Refuses to Defend*

An insured is often protected by several layers of insurance at the same time. Generally, the duty to defend rests with the primary carrier, and an excess insurer's duty to defend arises only when the primary insurer's liability limits are exhausted.¹⁶⁰ The duty is not triggered merely because the claims asserted in the tort action exceed the policy limits of the primary policy.¹⁶¹ Although an excess insurer usually does not have

Mut. Ins. Co., 784 F.2d 558 (4th Cir. 1986), it is difficult to imagine how an insured could detrimentally rely on the insurer's refusal to defend, especially if the insurer notified the insured in writing that it was disclaiming coverage. *Id.* at 563. A better case for estoppel is made when the insurer defends without a reservation of rights and then tries to assert that it has no duty to indemnify. See *infra* notes 243-285 and accompanying text. For a discussion of the application of equitable estoppel, see Note, *Insurance—Equitable Estoppel—Doctrine of Equitable Estoppel Used to Bar the Defense of Noncoverage by the Insurer and to Extend Coverage to Risks Not Provided for or Excluded Expressly in the Policy*, 15 VILL. L. REV. 505 (1970).

156. See *Oweiss v. Erie Ins. Exch. Co.*, 67 Md. App. 712, 720, 509 A.2d 711, 715-16 (1986); A. WINDT, *supra* note 71, § 4.35, at 213-16.

157. See *Washington Transit Auth. v. Bullock*, 68 Md. App. 20, 40, 509 A.2d 1217, 1227, *cert. denied*, 308 Md. 237, 238, 517 A.2d 1120, 1121 (1986).

158. A. WINDT, *supra* note 71, § 4.35, at 213 (quoted in *Rairigh*, 59 Md. App. at 317, 475 A.2d at 515); see also *St. Paul Fire & Marine Ins. Co. v. Molloy*, 291 Md. 139, 146-47 n.4, 433 A.2d 1135, 1139 n.4 (1981); cf. *Neuman v. Travelers Indem. Co.*, 271 Md. 636, 654, 319 A.2d 522, 531-32 (1974).

159. *Rairigh*, 59 Md. App. at 317, 475 A.2d at 515 (citing J. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4689 (Berdal ed. 1982)) ("Where there is no coverage, the greatest injury that the insured could have suffered by a failure to defend is the cost of defense—the judgment would have been his responsibility regardless."); see 14 G. COUCH, *CYCLOPEDIA OF INSURANCE LAW* § 51:73 (2d ed. 1982) (quoted with approval in *Rairigh*, 59 Md. App. at 318, 475 A.2d at 515).

160. For an explanation of excess and primary insurance, see *supra* notes 15, 17 and accompanying text.

161. See *Rairigh*, 59 Md. App. at 323, 475 A.2d at 517-18; cf. *Fireman's Fund v. Continental Ins. Co.*, 308 Md. 315, 519 A.2d 202 (1987) (excess carrier allowed to sue primary carrier for bad faith based on equitable subrogation principles; court did

a duty to defend, some excess policies require an excess insurer to defend if there is no other applicable insurance.¹⁶² Moreover, when a primary insurer wrongfully fails to defend, an excess insurer may be required to assume the defense in order to protect the insured's interests.¹⁶³

If the insured is covered by two insurers that are equally obligated to defend, and one refuses, the non-breaching insurer is entitled to recover part of the costs it incurred in the defense of the tort action¹⁶⁴ and all of the costs of prosecuting a declaratory judgment action. Similarly, if an excess insurer assumes the defense following the primary carrier's wrongful breach, the primary insurer is liable to the excess carrier for the litigation expenses and attorney's fees incurred in defending the underlying tort action and in bringing or defending a declaratory judgment action.¹⁶⁵ In either situation, the right of the non-breaching insurer to recover the costs of prosecuting the declaratory judgment action is based on the notion that the breaching carrier "authorized" the expense by its refusal to defend, as well as on contractual and equitable subrogation principles.¹⁶⁶

not decide if the primary carrier owed a direct and independent duty to the excess carrier). For a general discussion of the duties and obligations that run between primary and excess insurers, see Lanzone & Ringel, *Duties of a Primary Insurer to An Excess Insurer*, 61 NEB. L. REV. 259 (1982); Comment, *Primary and Excess Insurers and Their Common Insured: The Triangular Relationship with No Love Lost*, 32 CASE W. RES. L. REV. 265 (1981).

162. See *Rairigh*, 59 Md. App. at 323, 475 A.2d at 517-18.

163. See *Western World Ins. Co. v. Harford Mut. Ins. Co.*, 600 F. Supp. 313, 321 (D. Md. 1984), *aff'd in part and rev'd in part*, 784 F.2d 558 (4th Cir. 1986); see also *Employers Liab. Assurance Corp. v. Indemnity Ins. Co.*, 228 F. Supp. 896 (D. Md. 1964).

164. See *Ryder Truck Rental, Inc. v. Schapiro & Whitehouse*, 259 Md. 354, 269 A.2d 826 (1970). In *Ryder*, both insurers provided excess coverage only, and the court ruled that each would share the liability and defense costs equally. *Id.* at 364-65, 269 A.2d at 831-32; see also *Centennial Ins. Co. v. State Farm Mut. Auto. Ins. Co.*, 71 Md. App. 152, 164, 524 A.2d 110, 116 (both insurers provided "pro rata" coverage, and the court ruled that each would share the defense and liability costs "on the basis of their relative liability exposure"), *cert. denied*, 310 Md. 491, 530 A.2d 273 (1987).

165. *Travelers Indem. Co. v. Insurance Co. of N. Am.*, 69 Md. App. 664, 678-79, 519 A.2d 760, 767-68 (1987).

166. *Id.* at 677-80, 519 A.2d at 767-68 ("[I]nsurer is subrogated to claims of its insured against other insurer, whether *ex contractu* or *ex delicto*, once the insurer has indemnified the insured for his loss."); see also *Western World Ins. Co. v. Harford Mut. Ins. Co.*, 602 F. Supp. 36 (D. Md. 1985) (defending insurer's recovery against breaching insurer is based on principles of contractual and equitable subrogation), *aff'd in part and rev'd in part on other grounds*, 784 F.2d 558 (4th Cir. 1986). In *Travelers Indemnity*, the court also noted that "[t]he rights to which the insurer is subrogated have been broadly described as, 'all the rights of recovery of the insured of every nature, whatsoever.'" *Travelers Indemnity*, 69 Md. App. at 680, 519 A.2d at 768 (quoting *Svea Assurance Co. v. Packham*, 92 Md. 464, 465 (1901) (statements in appellants brief)). Contractual subrogation is also known as conventional subrogation. Equitable subrogation is sometimes called legal subrogation. For a discussion of the elements of both, see *Aetna Casualty & Sur. Co. v. Hartford Accident & Indem. Co.*, 74 Md. App. 539, 539 A.2d 239 (1988).

V. RECURRING ISSUES

A. *The Insured's Responsibilities*

If an insured has been sued and the claimant's pleadings raise a potentiality of coverage, the insured must comply with the policy's conditions precedent to successfully enforce the insurer's duties under the policy. Under most policies, the insured is contractually obligated to notify the insurer about a potential claim and to cooperate with the insurer in the investigation and defense of any claim made against him.¹⁶⁷ An insurer is relieved of its duties to defend and indemnify if the insured breaches either his duty to notify or his duty to cooperate and the breach results in actual prejudice to the insurer.¹⁶⁸

Under the standard policy, the insured must notify his insurer of potential claims as soon as is practicable.¹⁶⁹ In addition, if he is to receive the litigation protection afforded by the policy, the insured must make a timely request for a defense.¹⁷⁰ Notifying the insurer that he has been served with the claimant's pleadings and forwarding the pleadings to the insurer may not be enough to constitute a defense request,¹⁷¹ and an insured would be wise to send a written request to the insurer along with the pleadings. A request made after a judgment has been entered is clearly not timely, and the mere entering of the adverse judgment is affirmative evidence of actual prejudice to the insurer.¹⁷²

167. For a discussion of the standard cooperation clause, see 2 R. LONG & M. RHODES, *supra* note 67, § 14.01.

168. Section 482 of article 48A of the Maryland Annotated Code provides:

Where any insurer seeks to disclaim coverage on any policy of liability insurance issued by it, on the ground that the insured or anyone claiming the benefits of the policy through the insured has breached the policy by failing to cooperate with the insurer or by not giving requisite notice to the insurer, such disclaimer shall be effective only if the insurer establishes, by a preponderance of affirmative evidence that such lack of cooperation or notice has resulted in actual prejudice to the insurer.

MD. ANN. CODE art. 48A, § 482 (1986); see *Travelers Ins. Co. v. Godsey*, 260 Md. 669, 673, 273 A.2d 431, 433-34 (1971) (failure of insured to cooperate); *State Farm Mut. Auto. Ins. Co. v. Hearn*, 242 Md. 575, 581-84, 219 A.2d 820, 824-26 (1966) (lack of requisite notice).

169. Whether notice of an occurrence was given by the insured to the insurer as soon as practicable is a question of fact. See *Hearn*, 242 Md. at 581, 219 A.2d at 823.

170. *Washington v. Federal Kemper Ins. Co.*, 60 Md. App. 288, 297-98, 482 A.2d 503, 507-08 (1984), *cert. denied*, 302 Md. 289, 487 A.2d 292 (1985).

171. *But cf. California Shoppers, Inc. v. Royal Globe Ins. Co.*, 175 Cal. App.3d 1, 37-38, 221 Cal. Rptr. 171, 189 (1985) (constructive notice of a claim to insurer constitutes a request for a defense).

172. See *Washington*, 60 Md. App. at 296, 482 A.2d at 507. In *Washington*, the court held that the insurer had no duty to indemnify the insured because the notice of a claim made after a final judgment was affirmative evidence of prejudice to the insurer. *Id.* at 295-96, 482 A.2d at 507. The court also held that the insurer had no duty to reimburse the insured for the costs of defense because the facts at trial showed that the claim fell outside of the policy's coverage, implicitly suggesting that the insurer did not show that it had been relieved of its defense obligation on the grounds that it had been prejudiced by a late notice. *Id.* at 297-98, 482 A.2d at 507-08.

The insured's duty to cooperate requires him to make a complete and truthful disclosure of facts related to the occurrence. In addition, he has a good faith obligation to aid in formulating every legitimate defense to the underlying tort action and to render assistance at trial.¹⁷³ Only by fulfilling these duties will the insured receive the benefits of policy.¹⁷⁴

B. Conflict of Interest Between the Insurer and the Insured

The duty to defend under the standard policy can be broken into two distinct components: the insurer's right to control the defense, and the insurer's obligation to pay the cost of the defense.¹⁷⁵ An insurer is not relieved of its duty to defend its insured when a conflict of interest arises over the defense of the case.¹⁷⁶ The insurer must first inform the insured of the nature of the conflict and then give him a choice between accepting an independent attorney selected by the insurer and selecting his own attorney.¹⁷⁷ If the insured decides to choose his own attorney, the insurer must reimburse the insured for the reasonable costs of the defense.¹⁷⁸

There are two types of conflict of interest that can arise between an insurer and its insured, and care should be taken to distinguish between them. The first is a conflict with regard to the existence of the insurer's duty to indemnify the insured; the second is a conflict with regard to the insurer's conduct of the defense.¹⁷⁹ The former usually does not require that the insured be offered independent counsel. The latter usually requires independent counsel if the insurer's potential liability could be reduced by its method of conducting the defense.¹⁸⁰

Conflicts of interest over the conduct of the defense arise from those coverage questions which are "intertwined" in the underlying tort suit.

173. *Travelers Ins. Co. v. Godsey*, 260 Md. 669, 673, 273 A.2d 431, 433-34 (1971).

174. This assumes, of course, that the insurer has offered its insured a defense. A breaching insurer cannot require the insured to comply with technical policy conditions. See *infra* text accompanying notes 232-235.

175. See Comment, *The Insurer's Duty*, *supra* note 6, at 738.

176. *Id.*; see also *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 409-10, 347 A.2d 842, 851 (1975).

177. *Brohawn*, 276 Md. at 414-15, 347 A.2d at 854. What constitutes an "independent counsel" is a difficult question. It "may simply mean attorneys who are not direct employees of the insurer. Or, more expansively viewed, it may mean attorneys who do not regularly represent the insurer." Morris, *supra* note 137, at 487-88 (footnote omitted). Windt suggests that in order to be an independent counsel, an attorney retained by an insurer to represent an insured in a conflict of interest situation must not be asked to comment on any coverage question by the insurer. Moreover, the attorney's role must be explained to the insured in writing, and copies of the attorney's status reports should be sent to the insured. If these requirements are met, Windt concludes, "there is no reason why the insurer should, in theory, be precluded from hiring as independent counsel an attorney [whom] it has used in the past to represent the insurer's interests." A. WINDT, *supra* note 71, § 4.20, at 179.

178. *Brohawn*, 276 Md. at 415, 347 A.2d at 854. See generally Comment, *The Insurer's Duty*, *supra* note 6, at 738.

179. A. WINDT, *supra* note 71, § 4.18.

180. *Id.*

A conflict may also arise from a "separate and distinct" coverage question, but such a conflict does not require the insurer to offer the insured a choice of independent counsel.¹⁸¹ Independent counsel need be offered only if a potentiality of coverage is created by an intertwined factual issue and the insurer will be bound by the results in the underlying tort action.¹⁸²

Brohawn, in which the claimants raised both intentional tort and negligence claims, illustrates a common conflict of interest over the conduct of the case. The best result for both the insurer and the insured would have been for the insured to be found not liable on either of the claimants' theories. The insurer, however, would not have been obligated to pay if the insured were found liable on the intentional tort count, because intentional torts were not covered by the policy. Conversely, the insured would have preferred to be found liable, if at all, on the negligence count, which was covered by the policy. Moreover, both the insured and the insurer would have been bound by the results in the tort action. These differing interests require the insurer to offer the insured a choice of independent counsel in order to protect against the possible manipulation of the defense to establish noncoverage.

The existence of a conflict of interest over the conduct of the defense in a potentiality situation varies from case to case. A *Brohawn*-type complaint gives rise to an inherent conflict. The conflict of interest doctrine, however, is not limited to cases in which the pleadings allege negligence and intentional torts as alternative theories of recovery.¹⁸³ A conflict of interest over the conduct of the defense arises any time the insurer can shape the defense to establish noncoverage.¹⁸⁴ Intertwined coverage

181. One commentator, however, has argued that:

[A]n inherent conflict of interest exists whenever the insurer disclaims liability for a suit it seeks to defend. The insured may have legitimate fears regarding the insurer's motivation to settle or otherwise provide a vigorous defense. In addition, the ever present danger that the insured may be required to produce evidence not otherwise available to the insurer that could later be used to establish non-coverage justifies the insured's demand that the insurer relinquish exclusive control of the defense.

Comment, *Reservation of Rights Notices and Nonwaiver Agreements*, 12 PAC. L.J. 763, 777-78 (1981) (footnotes omitted) [hereinafter Comment, *Reservation of Rights*]. *Contra* A. WINDT, *supra* note 71, § 4.18.

182. See generally Browne, *supra* note 70, at 19 n. 5 ("If the results in the tort action are immaterial as far as the coverage question is concerned, neither party will have any incentive to force those results one way or the other, and there is no conflict.").

183. See *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 320, 475 A.2d 509, 516, cert. denied, 301 Md. 176, 482 A.2d 502 (1984).

184. In *Southern Md. Agric. Ass'n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295 (D. Md. 1982), the court stated:

[I]f the . . . claimants were to prevail at all, [the insurer] would certainly prefer that they do so with respect to any claim other than the [covered] claim. Under such circumstances, it is not unreasonable for the [insureds] to be concerned as to the adequacy of representation by counsel not independent of the insurer. Consequently, they are entitled to independent counsel under *Brohawn*.

questions, such as whether the insured was acting within the scope of his employment,¹⁸⁵ whether the insured was an employee or an independent contractor,¹⁸⁶ whether the insured acted as an employee or in some other capacity,¹⁸⁷ or even whether the insured's tortious acts fell within the applicable policy dates¹⁸⁸ create conflicts of interest over the defense of the case and require the insurer to offer the insured a choice of counsel.

Conflicts of interest in the conduct of the defense may also work to the disadvantage of an insurer.¹⁸⁹ The insurer may be tempted to shape the defense to establish noncoverage. The insured, on the other hand, may have a conflict with his obligation to cooperate with the defense because he has a desire to manipulate the facts to establish coverage. Providing the insured with independent counsel, however, eliminates only the possibility that the insurer will shape the defense to establish noncoverage. It does not prevent the insured from shaping the defense to establish coverage to the detriment of the insurer.¹⁹⁰

The insurer may use two strategies to prevent this outcome. First, even if independent counsel is chosen, the insurer may still monitor the case and participate in the investigation, defense and settlement.¹⁹¹ The insurer need relinquish only *exclusive* control of the defense. Nevertheless, participation in a defense conducted by independent counsel is not

Id. at 1304.

185. *See, e.g., St. Paul Fire & Marine Ins. Co. v. Pryseski*, 292 Md. 187, 195-96, 438 A.2d 282, 286-87 (1981); *Terra Nova Ins. Co. v. Chillum Corp.*, 71 Md. App. 552, 556-59, 526 A.2d 642, 644-45, *cert. denied*, 311 Md. 22, 532 A.2d 168 (1987).

186. *See, e.g., United States Fidelity & Guar. Co. v. National Paving & Contracting Co.*, 228 Md. 40, 49-54, 178 A.2d 872, 876-78 (1962).

187. *See, e.g., Ohio Casualty Ins. Co. v. Lee*, 62 Md. App. 176, 185, 488 A.2d 988, 992-93, *cert. denied*, 303 Md. 471, 494 A.2d 939 (1984).

188. *See, e.g., Southern Md.*, 539 F. Supp. at 1304.

189. *Browne, supra* note 70, at 24.

190. *Id.*

191. *See* Comment, *Reservation of Rights, supra* note 181, at 779. Such a participation occurred in *Saba v. Darling*, 72 Md. App. 487, 531 A.2d 696 (1987), *cert. granted*, 311 Md. 698, 537 A.2d 202 (1988), where Darling was sued for assault and negligence. The insurer complied with its *Brohawn* duty by supplying Darling with independent counsel to defend the negligence count, which was covered by the policy, and by paying for a private attorney retained by Darling to defend the noncovered assault count. At the close of his case, the plaintiff dismissed the assault count, evidently knowing that Darling's policy excluded coverage for bodily injury intended by the insured. *Id.* at 489 n.1, 531 A.2d at 696 n.1. Darling's attorneys then moved for judgment on the negligence count. The court denied the motion for judgment and let the case go to the jury. Although the jury returned a verdict for Darling, the insurer would have been collaterally estopped from denying a duty to indemnify if the jury had returned a verdict against him.

Had the plaintiff's attorney not dismissed the assault count, it is unlikely that either of Darling's attorneys would have moved for judgment on the negligence count, because the motion, if granted, would have exposed Darling to personal liability. Darling's private attorney would undoubtedly have tried to protect his client by letting the negligence count go to the jury. Darling's other attorney, although hired by the insurer, owed Darling his utmost loyalty and could not have jeopardized Darling's interests by moving for judgment on the negligence count in order to protect the insurer's interests.

an entirely effective way for an insurer to protect its interests. Because an insurer cannot directly advance its interests at the expense of the insured, participation often provides little more than means for monitoring the progress of a case.

A second and more effective means of controlling the insured's ability to shape the defense arises from the insurer's right to intervene in the suit to protect its own interests. An insurer with a potentiality issue that cannot be litigated in a separate declaratory judgment action has the right to intervene as a party in the underlying tort action brought against its insured.¹⁹² The insurer must have a legitimate interest in order to intervene and must make a timely motion.¹⁹³ The right is not unqualified, and certain safeguards must be met in order to protect the insured from being "cast adrift and left to fend for himself or herself against the wealth and resources of the carrier."¹⁹⁴ Before intervening, the insurer must fulfill its defense obligation by supplying independent counsel to its insured or by paying the costs of the insured's counsel.¹⁹⁵ This safeguard places both the insured and the insurer on an equal economic footing and prevents the insurer from wresting control of the tort litigation from the claimants and the insured.¹⁹⁶

Intervention is designed to prevent the insured, either by himself or in collusion with the claimant, from shaping the facts to establish coverage. If the insurer were not able to intervene, then it might be collaterally estopped from raising the intertwined factual issues in a subsequent action.¹⁹⁷ This fear of collusion between the insured and the claimant is well-founded, for inventive attorneys have attempted to bind an insurer by various means.¹⁹⁸ Nevertheless, intervention is not wholly satisfac-

192. *Allstate Ins. Co. v. Atwood*, 71 Md. App. 107, 523 A.2d 1066, *cert. granted*, 310 Md. 274, 528 A.2d 1286 (1987).

193. *Hartford Ins. Co. v. Birdsong*, 69 Md. App. 615, 519 A.2d 219 (1987) (intervention not allowed because of untimeliness of request and insurer's lack of sufficient interest). A "legitimate interest" is a "direct, significant legally protectable interest." *Id.* at 628, 519 A.2d at 226.

Maryland Rule 2-214 establishes two types of intervention: intervention of right and permissive intervention. *See* MD. R. 2-214(a), (b). The rule does not specify a time limit for filing a motion to intervene, except to state that the motion must be "timely." MD. R. 2-214(a), (b)(1). For a discussion of the factors to be considered in determining the timeliness of a motion to intervene, see *Maryland Radiological Soc'y v. Health Serv. Cost Review Comm'n*, 285 Md. 383, 402 A.2d 907 (1979).

194. *Atwood*, 71 Md. App. at 113, 523 A.2d at 1069.

195. *Id.* Only an insurer that honors its duty to defend by providing its insured with counsel or paying for the insured's choice of counsel may intervene. A disclaiming insurer has no right to intervene because it has no legally sufficient interest. *See Birdsong*, 69 Md. App. at 629-30, 519 A.2d at 226.

196. *Atwood*, 71 Md. App. at 114, 523 A.2d at 1070.

197. *See supra* notes 136-145 and accompanying text.

198. Collusion can exist at any stage in the litigation—in the pleading stage, in settlement negotiations between the claimant and the insured, and during trial. In *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 475 A.2d 509, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984), the court of special appeals noted that a consent judgment conditioned upon the claimant's collecting the judgment from the insured's

tory from the insurer's standpoint. It projects the question of the existence and availability of insurance into a tort action.¹⁹⁹ Furthermore, intervention by an insurer in an underlying tort action based on alternative theories of negligent and intentional acts might actually increase the insurer's exposure under the policy. At trial, for example, the insurer might argue that the insured acted intentionally to avoid the policy coverage for negligence. If, however, the jury found that the insured actually acted recklessly as well as negligently, and it awarded punitive damages, the insurer would have contributed unwillingly to its own liability exposure.²⁰⁰

Participation in the defense or outright intervention treats only a symptom of the conflict of interest problem. As the drafter of the policy, the insurer has the ability to treat the cause of the problem by redrafting its defense obligation. For example, it could make the duty to defend dependent on the duty to indemnify or on the claimant's alleging facts which are *actually* within coverage. An insurer could also include a provision limiting its duty to defend the insured when a conflict of interest arises.²⁰¹ The insured would then be responsible for his own defense costs, but the insurer would still face possible liability under its duty to indemnify. The advantage of these limiting provisions, however, should be weighed against the insurer's desire "to retain the absolute right to control the defense where it may be liable."²⁰²

A better approach may be for the insurer to limit its exposure by providing that, in the case of a conflict of interest, the insured does not have an unfettered choice of independent counsel but must choose from a list of attorneys provided by the insurer.²⁰³ Similarly, the policy could allow the initial choice to lie with the insured but require the insurer's

insurer would not bar the insurer from later denying coverage under its duty to indemnify. Giving a preclusive effect to such a consent judgment would leave the claimant and the insured free "to stipulate away the right of an absent insurer to raise a legitimate defense to its liability" when the claimant seeks garnishment after the entry of the court judgment. *Id.* at 322, 475 A.2d at 517. *But see* Steyer v. Westvaco Corp., 450 F. Supp. 384 (D. Md. 1978).

199. While the existence and contents of a liability insurance policy are discoverable under Maryland Rule 2-402(b), the fact that a party carries liability insurance is not admissible to show that the party acted negligently. *Snowwhite v. State ex rel. Tenant*, 243 Md. 291, 221 A.2d 342 (1966). It may be admissible for other purposes. *See generally*, 5 L. McLAIN, MARYLAND PRACTICE: MARYLAND EVIDENCE §§ 411.1, 411.2 (1987).

200. This conclusion assumes, of course, that punitive damages are not excluded by the policy. *See First Nat'l Bank v. Fidelity & Deposit Co.*, 283 Md. 228, 389 A.2d 359 (1978) (punitive damages must be expressly excluded from a policy). The *Brohawn* court addressed this issue briefly and from another direction, noting that the conflict of interest between Transamerica and Brohawn would place Transamerica in a position to expose its insured to potential punitive damages. *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 406, 347 A.2d 842, 849 (1975).

201. *Brohawn*, 276 Md. at 410, 347 A.2d at 851.

202. *Id.*

203. *See Employers' Fire Ins. Co. v. Beals*, 103 R.I. 623, 635, 240 A.2d 397, 404 (1968).

approval of the choice.²⁰⁴ Under either option, the insurer would retain partial control over the defense of the case and could participate in the settlement process. These choices are available to the insurers if they are willing to deviate from old, familiar procedures and standard policy language.²⁰⁵

C. Notice Pleadings

The "notice" theory of pleading underlying the Federal Rules of Civil Procedure²⁰⁶ creates an inherent conflict with the exclusive pleading rule.²⁰⁷ The Federal Rules require only that the allegations in a pleading be "simple, concise and direct"²⁰⁸ and that the pleading set forth a "short and plain statement of the claim showing that the [claimant] is entitled to relief."²⁰⁹ There is no requirement that a pleading state "facts" supporting the allegations.²¹⁰ While "no pleading system operates with sufficient precision to predict insurance coverage,"²¹¹ the notice pleading system assails the validity and efficacy of the exclusive pleading rule.²¹² The stricter pleading requirements of the past gave an insurer substantially more information on which to decide a duty-to-defend

204. In both Rhode Island and New York, the insured's choice of counsel in a conflict-of-interest situation must be approved by the insurer. The insurer can reject the insured's attorney, but must do so in good faith. *See id.* at 635, 240 A.2d at 404; *New York State Urban Dev. Corp. v. VSL Corp.*, 738 F.2d 61, 65-66 (2d Cir. 1984).

205. Insurers appear to be wedded to the standard forms, and change from standard provisions is a slow process. In 1978, for example, the court of appeals held that punitive damages were covered by liability policies unless specifically excluded from coverage. *First Nat'l Bank v. Fidelity & Deposit Co.*, 283 Md. 228, 389 A.2d 359 (1978). The obvious solution for the insurers was to exclude punitive damages from coverage, but most policies issued today still do not contain the necessary exclusion. *But see Treanor, Mischief with Malice: A Review of Liability for Punitive Damages and the Insured's Right to Indemnity Against An Exemplary Award*, 8 U. BALT. L. REV. 222, 263-70 (1979) (suggesting that the Maryland Insurance Division has hesitated to permit exclusion of punitive damages without explicit direction from the judiciary or legislature).

206. *See generally* 2 J. MOORE, J. LUCAS & G. GOTHER JR., *MOORE'S FEDERAL PRACTICE* ¶ 8.13, at 8-61 to 8-62 (2d ed. 1987) [hereinafter *MOORE'S FEDERAL PRACTICE*]. The purpose of the Federal Rules "is to give fair notice of the claim asserted so as to enable the adverse party to answer and prepare for trial, to allow for the application of the doctrine of *res judicata*, and to show the type of case brought, so that it may be assigned to the proper form of trial." *Id.*

207. *See supra* notes 29-48 and accompanying text.

208. FED. R. CIV. P. 8(e)(1).

209. *Id.* 8(a)(2).

210. *MOORE'S FEDERAL PRACTICE*, *supra* note 206, § 8.13, at 8-60, 8-66.

211. 1A R. LONG & M. RHODES, *supra* note 67, § 5.02.

212. This observation, made by many commentators, is summed up nicely by Long and Rhodes:

Indeed, notice pleading may become so ambiguous and non-committal that the defendants do not reasonably know what is being alleged. In addition, due to the vague nature of notice pleadings, it is quite common today for an insurer to either know of or be able to readily discover facts which would require it to defend if actually pled by the claimant.

Id.

question.²¹³ The continued viability of the exclusive pleading rule in light of the notice theory underlying current pleading systems has been questioned by both commentators²¹⁴ and the courts.²¹⁵

The Maryland Rules of Civil Procedure, although modeled after the Federal Rules, have not adopted the "notice" theory of pleading.²¹⁶ Like the Federal Rules, the Maryland Rules require that a complaint be "simple, concise and direct."²¹⁷ Unlike the federal mandate of a "short and plain statement of the claim," however, the Maryland Rules require "a clear statement of the facts necessary to constitute a cause of action."²¹⁸ From an insurer's standpoint, the Maryland Rules' retention of "fact" pleading alleviates much of the insurer's burden of determining whether it must defend its insured.

Nevertheless, the Maryland Rules are problematic in determining when a pleading establishes an insurer's duty to defend. With technical forms of pleading eliminated,²¹⁹ the Maryland Rules can be considered a modified "notice" pleading system. The rules allow a claimant to "set forth two or more statements of a claim . . . alternatively or hypothetically."²²⁰ Moreover, a claimant "may also state as many separate claims

213. See *Babcock & Wilcox v. Parsons*, 430 F.2d 531 (8th Cir. 1970). See generally MOORE'S FEDERAL PRACTICE, *supra* note 206, §§ 8.04, 8.13.

214. See, e.g., Comment, *The Insurer's Duty*, *supra* note 6, at 749.

215. See, e.g., *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966). In *Ritchie v. Anchor Casualty Co.*, 135 Cal. App. 2d 245, 286 P.2d 1000 (1955), the court criticized the exclusive pleading rule, stating that "[t]he draftsman of the complaint against the insured is not interested in the question of coverage which later arises between insurer and insured." *Id.* at 251, 286 P.2d at 1003. This conclusion, however, is questionable. In most cases, the draftsman is concerned with the question of insurance, since the existence of insurance may provide his client with a means of recovering a judgment from an otherwise insolvent party. The facts of *Brohawn*, for example, demonstrate that the plaintiffs' attorney amended the complaint by adding a negligence count in order to provide his clients access to Brohawn's liability policy. See *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 400-01, 347 A.2d 842, 846 (1975); see also *supra* notes 53-56 and accompanying text. This practice is quite common in cases centering on an assault, and almost every plaintiffs' attorney knows that he should add a simple negligence count in order to create a "potentiality of coverage." See Browne, *supra* note 70, at 27-28.

216. Compare Md. R. 2-303(a) ("All averments of claim . . . shall be made in numbered paragraphs, the contents of each of which shall be limited as far as practicable to a statement of a single set of circumstances . . .") with *id.* 2-303(b) ("A pleading shall contain only such statements of fact as may be necessary to show the pleader's entitlement to relief or ground of defense."). See generally P. NIEMEYER & L. RICHARDS, MARYLAND RULES COMMENTARY 135 (1984) (Rule 2-305 "continues the distinction which has always existed between pleading in the Maryland Courts and the federal courts. While F[ed]. R. Civ. P. 8(a) requires that a pleading contain a short and plain statement of the claim showing that the plaintiff is entitled to relief, [Maryland Rule 2-305] requires a statement of facts essential to state a cause of action.").

217. Md. R. 2-303(b).

218. *Id.* 2-305; cf. *id.* 2-303(b) (A complaint shall "contain only such statements of fact as may be necessary to show the pleader's entitlement to relief. . .").

219. *Id.* 2-303(b).

220. *Id.* 2-303(c).

or defenses as [he] has, regardless of consistency and whether based on legal or equitable grounds.”²²¹ The admonition that a pleading be “simple, concise and direct,” along with acceptance of multiple count complaints and inconsistent allegations, affect the insurer’s defense responsibility by creating a pleading environment in which “potentialities” of coverage based on ambiguous, vague, incomplete, or broad and conclusory allegations flourish.

Both the Federal and Maryland Rules provide mechanisms for allowing an insurer to assess its duty to defend when it is faced with a bare-bones or ambiguous pleading. A motion for a more definite statement and the various discovery devices can be used to help an insurer evaluate its duty to defend completely, but these procedures can only be used *after* the insurer has assumed the defense. Thus, an insurer faced with a bare-bones or ambiguous pleading under either the Federal or the Maryland Rules should assume the defense under a reservation of rights,²²² then monitor the case closely to determine if information obtained through the normal litigation process relieves it of its duty to defend.²²³ If the information shows that its defense duties have ended, the insurer should file a declaratory judgment action to have the court determine its rights. A prudent insurer will not withdraw without obtaining a court declaration that its defense obligation has ceased.

D. Apportionment

If the insurer has a duty to defend any part of a multiple-count lawsuit, then it generally has the duty to defend the entire lawsuit.²²⁴ In the usual case, when the insurer assumes the defense it is responsible for defending all the allegations against the insured, not merely those that fall actually or potentially within the coverage.²²⁵ In some situations, however, when defense costs can be readily apportioned between covered and noncovered items, the insurer can provide a partial defense. This can be done in two ways. If the insured has accepted the insurer’s independent counsel, then the independent counsel would defend only those counts which fall actually or potentially within coverage. The insured would be responsible for retaining his own attorney to defend those counts that fall

221. *Id.*

222. *See infra* notes 249-256 and accompanying text.

223. In *Steyer v. Westvaco Corp.*, 450 F. Supp. 384 (D. Md. 1978), the court stated that the insurer had a continuing duty to defend that would be relieved when, if ever, the facts showed that the claimant’s claims were limited to those outside of coverage. *Id.* at 389; *see also supra* notes 110-112 and accompanying text.

224. *See, e.g.,* *Southern Md. Agric. Ass’n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295, 1299 (D. Md. 1982); *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 407-08, 347 A.2d 842, 850 (1975); *Loewenthal v. Security Ins. Co.*, 50 Md. App. 112, 436 A.2d 493 (1981), *cert. denied*, 292 Md. 596 (1982); *Minnick’s, Inc. v. Reliance Ins. Co.*, 47 Md. App. 329, 422 A.2d 1028 (1980); *accord* *Continental Casualty Co. v. Board of Educ.*, 302 Md. 516, 489 A.2d 536 (1985).

225. *See* *Harford Mut. Ins. Co. v. Jacobson*, 73 Md. App. 670, 678-79, 536 A.2d 120, 124, *cert. denied*, 312 Md. 601, 541 A.2d 964 (1988).

outside of coverage.²²⁶ Alternatively, if the insured has selected his own independent attorney, then the insurer would pay that attorney for the cost of defending the counts that fall actually or potentially within coverage. In a multiple count claim, for instance, an insurer may apportion the defense costs between counts that are actually or potentially covered and counts that are not covered, if there is a reasonable means of properly apportioning the costs.²²⁷ In the usual case, however, there is no reasonable means of prorating the costs, and separate representation for covered and noncovered counts is not feasible.²²⁸

If apportionment is possible and the insured has retained his own counsel, then the insurer is responsible only for the fees and expenses that are reasonably related to the defense of a covered claim.²²⁹ Legal fees and services are reasonably related to a covered count if they would have been rendered by reasonably competent counsel engaged to defend a suit involving only the covered count.²³⁰ The insured has the burden of proving that a given item of legal expense or service was reasonably related to the defense of a covered count.²³¹

VI. AN INSURER'S ALTERNATIVES

A. *Decline to Defend*

An insurer faced with a potentiality question has several alternatives.²³² First, it may refuse to defend. This approach is neither practical nor advisable. A disclaiming insurer waives its right to rely on technical policy defenses and provisions.²³³ It also loses the right to insist on the insured's cooperation with the investigation and defense of the underlying tort action, and it surrenders the ability to select defense counsel and control the litigation. The insurer's disclaimer also allows the insured to enter into settlements and releases without the insurer's consent, thus

226. See *Minnick's*, 47 Md. App. at 333-34, 422 A.2d at 1029-30.

227. See *Steyer*, 450 F. Supp. at 390; see also *Reliance Ins. Co. v. Mogavero*, 640 F. Supp. 84 (D. Md. 1986). In *Mogavero*, the court noted that requiring an insurer to provide a defense for all of the claims in a multiple count complaint, where it was clear that there was no potentiality of coverage for the overwhelming majority of the claims, would substantially expand the insurer's obligations under the policy beyond those reasonably contemplated by the parties. *Id.* at 87.

228. Compare *Brohawn*, 276 Md. at 407, 347 A.2d at 850-52 (separate representation not feasible) with *Minnick's*, 47 Md. App. at 333-34, 422 A.2d at 1030 (separate representation feasible).

229. *Continental Casualty Co. v. Board of Educ.*, 302 Md. 516, 489 A.2d 536 (1985).

230. *Id.* at 532, 489 A.2d at 544.

231. *Id.* But see *Southern Md. Agric. Ass'n v. Bituminous Casualty Corp.*, 539 F. Supp. 1295 (D. Md. 1982) (insurer may bear burden of proving feasibility of apportionment).

232. Cf. *Glens Falls Ins. Co. v. American Oil Co.*, 254 Md. 120, 136, 254 A.2d 658, 666-67 (1969) (an insurer has three options: decline to defend; defend under reservation; or seek declaratory judgment). See generally *Dohoney*, *supra* note 6, at 471.

233. See *United States Fidelity & Guar. Co. v. National Paving & Contracting Co.*, 228 Md. 40, 47-49, 178 A.2d 872, 875-76 (1962).

destroying the insurer's subrogation rights.²³⁴ Finally, a refusal to defend may lead to the insurer's breaching its good faith duty to settle within policy limits.²³⁵

Under some circumstances it may appear that there are legitimate practical and tactical reasons for flatly refusing to defend. An insurer faced with a potentiality problem would save the cost of defense if it were subsequently shown that the refusal was proper. Furthermore, even where coverage is fairly certain, an insurer might weigh the likelihood of various outcomes and conclude that the benefits of disclaiming coverage outweigh the risks.²³⁶

Perhaps the primary reason for not defending is the belief that the denial will control defense costs by making the insured's attorney aware that he might have to look solely to a cost-conscious client for his fees, rather than to the economic resources of an insurance carrier. Although this theory is attractive, its true economic value is questionable. The insured's independent counsel is already restrained by the concept of "reasonable" attorney's fees. In addition, the insured's attorney may charge a higher hourly rate than does the insurer's defense counsel, thus nullifying the economic benefit of limiting the insured's attorney's hours. The insurer is not entitled to determine the reasonableness of the fees by comparing them to insurance defense counsel fees; reasonable fees are determined by the market as a whole, not by the insurance defense market.²³⁷ The insurer's ability to restrain the fees of an independent counsel is therefore doubtful at best.²³⁸

Other factors indicate that disclaiming coverage, even in those cases involving "close" coverage questions, is extremely risky. A judgment against the insured may be substantially higher than if the insurer had defended and thus had been able to control the litigation.²³⁹ Furthermore, if courts extend the tort of bad faith to the duty to defend, an insurer that refuses to defend for economic reasons could be held liable for consequential damages beyond ordinary contract damages.²⁴⁰

The final reason for refusing to defend is that it places the burden on the insured to file a declaratory judgment action to establish the insurer's defense duty.²⁴¹ This small benefit is substantially outweighed by the fact

234. A. WINDT, *supra* note 71, § 3.10, at 123; *see also id.* § 5.15, at 261.

235. *See id.* § 5.01, at 232-35.

236. The insurer's benefits would be maximized, for example, if the refusal to defend acts as an additional economic restraint on the insured's counsel; if the insured is likely to prevail in the underlying tort action or settlement is likely to be either moderate or based on matters outside coverage; and if the insurer is able to settle the insured's declaratory judgment action and claim for damages arising from the insurer's breach for a reduced amount.

237. *See Browne, supra* note 70, at 25.

238. *See Comment, Reservation of Rights, supra* note 181, at 779.

239. *See Browne, supra* note 70, at 25.

240. *See infra* notes 286-307 and accompanying text.

241. The statute of limitations, under the discovery standard generally applicable in Maryland, begins to run when the insured discovers that the insurer will not defend.

that the insurer will be responsible for the insured's attorney's fees in both a declaratory judgment action, if the insured is successful, and in the underlying tort action.

In general, then, an insurer's option of refusing to defend is usually outweighed by practical considerations. The decision to decline to defend must be a studied one, and it will be the rare case where it will be found advisable. Moreover, if the tort of bad faith is extended to the duty to defend, then refusing to defend will lose what little practical and tactical advantage it has. Accordingly, an insurer should hesitate to refuse to defend in all but the clearest of cases.

B. Defend Without Reservation

The second alternative for an insurer faced with a potentiality issue is to defend without reservation. This is equally as unappealing as the first alternative. An insurer that defends without reservation will be deemed to have waived its technical policy defenses,²⁴² and under certain circumstances, it may also be estopped from asserting substantive policy defenses.²⁴³ In particular, it may be prevented from asserting that it has no duty to indemnify the insured if the insured can establish that he detrimentally relied on the insurer's assuming the defense without reservation.

Although it is clear that insurance coverage cannot be created or expanded by the doctrine of waiver,²⁴⁴ there is some question whether it

See *Mraz v. American Universal Ins. Co.*, 616 F. Supp. 1173, 1177 (D. Md. 1985) (citing *American Home Assurance Co. v. Osbourn*, 47 Md. App. 73, 84, 422 A.2d 8, 14-15 (1980), *cert. denied*, 289 Md. 739 (1981)), *rev'd sub nom. on other grounds*, *Mraz v. Canadian Universal Ins. Co.*, 804 F.2d 1325 (4th Cir. 1986).

242. *Columbia Casualty Co. v. Ingram*, 154 Md. 360, 140 A. 601 (1928); *London & Lancashire Indem. Co. v. Cosgriff*, 144 Md. 660, 125 A. 529 (1924).

243. In considering whether an insurer may waive an inapplicability of its policy, the court of appeals, in *Bowers & Kaufman v. Bothwell*, 152 Md. 392, 136 A. 892 (1927), noted that:

[I]t is not a forfeiture that is to be found waived, nor a violation of a condition or any irregularity; it is an inapplicability of the policy, so that the waiver argued for would be, in effect, an extension of the contract beyond its defined limits, or a new contract. Such an extension would, at least, we think, require an estoppel, if not a new consideration, to support it.

Id. at 397, 136 A. at 894. In *Prudential Ins. Co. v. Brookman*, 167 Md. 616, 175 A. 838 (1934), the court, after reviewing its decision in *Bowers*, stated:

And it is doubted whether an estoppel, strictly speaking, could suffice to create a new contract. . . . Waiver or estoppel can only have a field of operation when the subject-matter is within the terms of the contract. . . . Whatever the description of the process, it must include the ordinary essentials of a contract and among them a meeting of the minds of the parties in the [extension of the original contract].

Id. at 620-21, 175 A. at 840; *see also supra* notes 152-159 and accompanying text.

244. *American Auto Ins. Co. v. Master Bldg. Supply & Lumber. Co.*, 179 F. Supp. 699 (D. Md. 1959); *see also supra* notes 152-159 and accompanying text.

can be extended by the doctrine of estoppel.²⁴⁵ Maryland cases invariably treat waiver and estoppel together and then conclude simply that coverage cannot be created by waiver.²⁴⁶ What the courts seem to suggest in their analyses is that as a matter of law, waiver cannot expand coverage, and under the facts of the various cases, estoppel will rarely expand coverage.²⁴⁷ The implication of these analyses, however, is that under proper circumstances an insurer can be estopped from denying it has a duty to indemnify. For example, if the potentiality of coverage created a conflict of interest and the insured was not allowed to choose his own counsel, then the insured's reliance on the insurer's unqualified defense and his forfeiture of his right to independent counsel might justify finding an estoppel. The insured surely has been misled; whether he has been injured and has changed his position for the worse will depend upon the facts of each case.²⁴⁸ If estoppel can expand coverage under these circumstances, then an insurer that chooses to defend without reserving its right to raise a defense to its duty to indemnify may be precluded from later asserting that it has no duty to indemnify.

C. *Defend Under Reservation*

A third alternative, and the preferable one, is for the insurer to offer the insured a defense under either a non-waiver agreement or a reservation-of-rights notice. The insurer can then pursue a declaratory judg-

245. See *Snyder v. Travelers Ins. Co.*, 251 F. Supp. 76 (D. Md. 1966) (applying Maryland law). Noting that the subject matter of the insurance coverage may not be extended by waiver, the court stated that this rule "may not be correct as to the doctrine of estoppel." *Id.* at 80. The court, however, concluded that under the facts of the case, the essential elements of an estoppel were missing. *Id.*

246. For an example of this type of analysis, see *Washington Metro. Area Transit Auth. v. Bullock*, 68 Md. App. 20, 39-40, 509 A.2d 1217, 1226-27, *cert. denied*, 308 Md. 237, 517 A.2d 1120 (1986).

247. See *Haines v. St. Paul Fire & Marine Ins. Co.*, 428 F. Supp. 435 (D. Md. 1977) (applying Maryland law). In *Haines*, the court stated:

Even assuming that in a proper case, coverage can be afforded or extended by estoppel . . . the rule in Maryland is that: For principles of estoppel to be applicable, the party claiming the benefit of estoppel must have been misled to his injury and changed his position for the worse, having believed and relied upon the representations of the party sought to be estopped.

Id. at 442 (citations omitted). The court, after stating the necessary elements of an estoppel, concluded:

In the face of the clear language of the St. Paul [reservation-of-rights] letter, plaintiffs cannot assert a good faith reliance based on prior or subsequent acts by St. Paul. Plaintiffs accepted the defense subject to the conditions imposed in the letter which included St. Paul's absolute right to withdraw at any time upon written notice. . . . Knowing the limits of St. Paul's undertaking, plaintiffs cannot assert that defendant is estopped from denying coverage.

Id. at 443; see also *Snyder*, 251 F. Supp. at 80 (applying Maryland law) (essential elements of an estoppel were missing under the facts of the case).

248. See *Haines*, 428 F. Supp. at 442.

ment action²⁴⁹ if coverage hinges on issues "independent and separable" from the underlying tort action.

When an insurer wants to defend despite a conflict of interest, it should, as a precaution, make its position known to its insured by either entering into a non-waiver agreement with the insured or by sending the insured a reservation-of-rights notice. Non-waiver agreements and reservation-of-rights notices are designed to allow the insurer to honor its duty to defend while preserving its right to deny coverage under its duty to indemnify. These precautionary devices benefit both the insurer and the insured.²⁵⁰ The non-waiver agreement or reservation-of-rights notice allows the insurer to control the defense, contain defense costs, effect a reasonable settlement and avoid litigation expenses in a declaratory judgment action. The insured in turn receives a defense, avoids litigation expenses in a declaratory action and receives the benefit of any settlement entered into by the insurer.²⁵¹

Both non-waiver agreements and reservation-of-rights notices are valid in Maryland.²⁵² The former is a bilateral agreement between the insurer and insured; the latter is a unilateral notice, usually in the form of a letter from the insurer, which becomes binding if the insured does not object.²⁵³ The agreement and notice are designed to inform the insured that while the insurer is defending the action, it believes it has no obligation to indemnify him.

Although Maryland courts have recognized the existence and extensive use of both non-waiver agreements and reservation-of-rights notices,²⁵⁴ the courts have not clearly delineated what they must contain to be valid. In order to be effective, non-waiver agreements and reservation-of-rights notices should provide sufficient information to enable the insured to make an informed judgment on whether he wants the insurer to continue with the defense.²⁵⁵ A reservation-of-rights notice should also indicate that the insured's silence will constitute an acceptance of the

249. An insurer also has the option to seek declaratory relief if it declines to defend or defends without reservation. See Note, *Use of the Declaratory Judgment to Determine a Liability Insurer's Duty to Defend—Conflict of Interests*, 41 IND. L. REV. 87, 92 (1965).

250. See *American Auto. Ins. Co. v. Master Bldg. Supply & Lumber Co.*, 179 F. Supp. 699, 705 (D. Md. 1959).

251. See generally Comment, *Reservation of Rights*, *supra* note 181, at 764.

252. *Island Mut. Ins. Co. v. Davenport*, 247 F. Supp. 387 (D. Md. 1965).

253. *Id.* at 392.

254. See *Master Bldg. Supply & Lumber Co.*, 179 F. Supp. at 704-05; see also *Hardware Mut. Casualty Co. v. Mitnick*, 180 Md. 604, 26 A.2d 393 (1942).

255. Not every reservation-of-rights letter gives rise to a conflict of interests. See generally A. WINDT, *supra* note 71, § 4.18, at 169-74. One commentator has stated that a non-waiver agreement or a reservation-of-rights notice must provide the insured with enough information for him to make "a knowing, intelligent wavier" of his right to an unconditional defense. Comment, *Reservation of Rights*, *supra* note 181, at 785-86. In a conflict of interest situation, non-waiver agreements or reservation-of-rights notices should contain the following information:

1. A clear denial of liability under the duty to indemnify;

insurer's offer to defend.²⁵⁶ Once the insurer has properly reserved its right to contest its duty to indemnify, it can then decide whether it is possible and desirable to pursue a declaratory judgment action at the same time that it defends the underlying tort action.

The insurer's alternative of defending under a reservation of rights and, if feasible and desirable, pursuing a declaratory judgment is clearly the approach favored by the Maryland courts. Under *Brohawn* and its progeny, the insurer has a near absolute duty to defend whenever its insured is sued. This places the burden on the insurer to bring a declaratory judgment action to determine that no coverage exists. It also fulfills the insured's reasonable expectations and otherwise protects the insured from the insurer's mistakes of judgment in evaluating its duty to defend. The logical extension of the *Brohawn* rule is to find that the insurer has an absolute duty to defend whenever its insured is sued, unless a court declares that no duty to defend exists.

VII. EMERGING PROBLEMS

A. *Beyond the Text: The Duty to Investigate*

Under the exclusive pleading rule, an insurer determines whether it should defend its insured by comparing the allegations in the claimant's pleadings to the scope of coverage offered by the policy.²⁵⁷ If the allegations fall actually or potentially within the insurer's duty to indemnify, then the insurer must defend even if it possesses knowledge that demonstrates no duty to indemnify actually exists.²⁵⁸ On its face, the exclusive pleading rule benefits the insured. It can work to the insured's detriment, however, if the alleged facts indicate that the insurer does not have a duty to indemnify, but the duty exists under the actual facts of the controversy. In such a case, the insurer would not ordinarily be obligated to defend.²⁵⁹ The inequity of this result has led courts to carve out

2. A clear statement that the insurer is defending the action but believes that it may not have a duty to indemnify;

3. An explanation of the denial of coverage, including a description of the specific grounds and provisions of the policy on which the denial is based;

4. A complete disclosure of the existence and nature of the conflict of interest;

5. Detailed notification of the insured's *Brohawn* options, with specific reference to the insured's right to decline the insurer's offer of a defense and his right to choose an independent counsel to conduct his defense at the insurer's options;

6. A recommendation that the insured seek the advice of counsel before signing the non-waiver agreement or agreeing to the reservation-of-rights notice.

Id.

256. *Id.* at 786-87.

257. See *supra* notes 29-48 and accompanying text.

258. See *supra* notes 62-72 and accompanying text.

259. This is a situation where the insurer would have no duty to defend but might have a duty to indemnify.

an exception to the exclusive pleading rule which requires the insurer to defend when the alleged facts show noncoverage but the actual facts indicate coverage.²⁶⁰ Maryland courts have not had the opportunity to consider the validity of the exception,²⁶¹ but it would be a logical and natural extension of *Brohawn* and its progeny.²⁶²

The exception to the exclusive pleading rule requires the insurer to defend its insured if it knows or should know of facts that indicate a possibility of coverage, notwithstanding allegations that indicate noncoverage.²⁶³ The exception flows naturally from the *Brohawn* rule because in determining the intent of the parties to an insurance contract, the courts consider the reasonable expectations of the insured,²⁶⁴ and under a standard liability policy, an insured reasonably expects that the insurer will defend him whenever there is a potentiality of coverage based on a claim.²⁶⁵ The insured surely does not expect that the insurer's duty to

260. There is a conflict among the jurisdictions as to the applicability of the exclusive pleading rule "when the insurer has knowledge of actual facts which are different from those alleged in the underlying complaint." *American Policyholders' Ins. Co. v. Cumberland Cold Storage Co.*, 373 A.2d at 247, 250 n.1 (Me. 1978). A growing number of courts apply the "factual inclusionary" exception. See Note, *Liability Insurer's Duty to Defend: American Policyholders' Ins. Co. v. Cumberland Cold Storage Co.*, 30 ME. L. REV. 295, 295-96 (1979) [hereinafter Note, *Liability Insurer's Duty*].

261. *But see Terra Nova Ins. Co. v. Chillum Corp.*, 71 Md. App. 552, 559, 526 A.2d 642, 645, *cert. denied*, 311 Md. 22, 532 A.2d 168 (1987). Although the opinion in *Terra Nova* is not clear, it can be read as an application of the factual test.

262. Windt observes that the logic behind the exception is "unassailable." A. WINDT, *supra* note 71, § 4.03, at 137. The foundation for the exception can be found in *Lee v. Aetna Casualty & Sur. Co.*, 178 F.2d 750 (2d Cir. 1949). There, Judge Hand wrote:

The only exception [to the exclusive pleading rule] we can think of is that the injured party might conceivably recover on a claim which, as he had alleged it, was outside the policy; but which, as it turned out, the insurer was bound to pay. Such is the plasticity of modern pleading that no one can be positive that that could not happen. In such a case of course the insurer would not have to defend; yet, even then, as soon as, during the course of the trial, the changed character of the claim appeared, we need not say that the insured might not insist that the insurer take over the defence.

Id. at 752-53 (cited with approval by *Brohawn v. Transamerica Ins. Co.*, 276 Md. 396, 408, 347 A.2d 842, 850 (1975)).

263. A. WINDT, *supra* note 71, § 4.03, at 136-37.

264. For a discussion of the doctrine of reasonable expectations, see Kelso, *Idaho and The Doctrine of Reasonable Expectations: A Springboard for an Analysis of a New Approach to a Valuable But Often Misunderstood Doctrine*, 47 INS. COUNSEL J. 325 (1980).

265. In considering the insured's duty to defend in *Brohawn*, for example, the court of appeals stated:

By clear and unequivocal language, Transamerica has assumed the obligation of relieving its insured of the expense of defending an action alleging and seeking damages within the policy coverage. Additionally, the insured could reasonably expect that the insurer will employ its vast legal and investigative resources to defeat the action for the mutual benefit of both the insurer and the insured.

defend will turn on the manner in which the claimant's attorney drafts a complaint.²⁶⁶ The exception to the exclusive pleading rule furthers the insured's reasonable expectations by focusing on actual facts rather than on allegations. The insurer, as one court phrased it, "cannot construct a formal fortress of the [claimant's] pleadings and retreat behind its walls."²⁶⁷

The expectations of the insured are likely to be put at issue in the first place because the standard policy is silent on the insurer's duty to defend when allegations indicate noncoverage but the actual facts indicate coverage.²⁶⁸ This silence cannot be read to obviate the insurer's duty to defend under such circumstances.²⁶⁹ If an insurer intends to relieve itself of the obligation to defend when allegations indicate noncoverage, it can make its intent "clear and unmistakable" by drafting a provision to reflect its intent.²⁷⁰ The courts have tended to resolve ambiguities in the standard provision in favor of the insured,²⁷¹ thus providing

Brohawn, 276 Md. at 409, 347 A.2d at 851.

The doctrine of reasonable expectations, however, is broader than the general rule of *contra proferentem* followed in Maryland because it allows a court to honor the insured's reasonable expectations even when these expectations have been limited by unambiguous language in the policy. The doctrine is closely related to an adhesion contract analysis. In light of Maryland's long recognition that unambiguous language will be afforded its ordinary and customary meaning even if it creates a hardship for the insured, *Brohawn* should not be read as an implicit adoption of the doctrine of reasonable expectations. Rather, the insured's reasonable expectations are but one factor to consider in determining the intent of the parties to an insurance policy.

266. Comment, *The Insurer's Duty*, *supra* note 6, at 738.

267. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 276, 419 P.2d 168, 176, 54 Cal. Rptr. 104, 112 (1965); *see also Rowell v. Hodges*, 434 F.2d 926, 930 (5th Cir. 1970) ("[T]o say that the [insurer] must gauge its obligation strictly by the pleading called a Complaint, and put blinders on, so to speak, to what it actually knows and has definitely ascertained, is somewhat archaic, considering the nature of our present system of notice pleading."); *Transport Ins. Co. v. Michigan Mut. Liab. Ins. Co.*, 340 F. Supp. 670, 677 (E.D. Mich. 1972) (An insurer should not be allowed to escape its contractual duty to defend "by ignoring the true facts in reliance upon an ill-founded complaint."). *Gray* has generated substantial commentary. *See, e.g., Note, The Insurer's Duty to Defend Made Absolute: Gray v. Zurich*, 14 UCLA L. REV. 1328 (1967).

268. *See McGettrick v. Fidelity & Casualty Co.*, 264 F.2d 883, 886 (2d Cir. 1959); *see also supra* note 1.

269. Garbett, *supra* note 6, at 264-65.

270. *In Loftin v. United States Fire Ins. Co.*, 106 Ga. App. 287, 127 S.E.2d 53 (1962), the court stated:

If the insurer intended otherwise, it could have made its intent clear and unmistakable by undertaking to defend 'unless the complaint alleges facts which show the claimant to be excluded from coverage,' or by using other unambiguous language, for example: 'The company shall defend claims and suits, groundless or otherwise, for which it may become liable only when the allegations thereof show injury covered by the policy and do not show the claim to be excluded by the policy.'

Id. at 293, 127 S.E.2d at 58.

271. *See A. WINDT, supra* note 71, § 4.02.

further justification for the adoption of a factual exception to the exclusive pleading rule.

The exception's requirement that an insurer defend if it "knows or should know" of facts indicating a possibility of coverage necessarily requires the insurer to investigate the facts surrounding a claim.²⁷² From an insurer's standpoint, the investigation requirement makes sense. The insurer is not merely concerned with saving litigation expenses; its primary concern is with limiting its exposure under its duty to indemnify.²⁷³ It will best control the cost of indemnification by promptly investigating claims to determine whether it could be required to indemnify, and if it could, by entering into the litigation and settlement process.²⁷⁴ Accordingly, imposition of a duty to investigate on the insurer fulfills the insured's reasonable expectation of a defense for a claim within coverage and is consistent with Maryland law.²⁷⁵

B. Extrinsic Evidence Used to Rebut a Duty to Defend Raised by the Pleadings

Although extrinsic facts may be admissible under the factual exception to the exclusive pleading rule, an insurer generally cannot use extrinsic facts to determine its duty to defend if the allegations giving rise to the defense obligation are materially intertwined in the underlying tort action.²⁷⁶ Recently, however, Maryland courts have suggested that extrinsic facts can be used by the insurer to determine its duty to defend under certain limited circumstances. If the pleadings on their face give rise to a duty to defend based on facts that are not material to the underlying tort action, then the insurer may look to the actual facts, not the alleged facts, to determine its duty to defend.²⁷⁷ Similarly, an insurer can

272. See generally Comment, *The Insurer's Duty*, *supra* note 6; Note, *Liability Insurer's Duty*, *supra* note 260.

273. Accord A. WINDT, *supra* note 71, § 4.03.

274. See Comment, *The Insurer's Duty*, *supra* note 6, at 749.

275. The Maryland Annotated Code provides that:

(d)The following actions by an insurer . . . if committed with such frequency as to indicate a general business practice, are unfair claim settlement practices and are violations of this section. . . .

(3) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies;

(4) Refusing to pay claims without conducting a reasonable investigation based on all available information.

MD. ANN. CODE art. 48A, § 230A(d)(3)-(4) (1986).

276. See *supra* notes 94-114 and accompanying text.

277. *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 320-21, 475 A.2d 509, 516, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984) (citing *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 267 A.2d 7 (1970)). For example, suppose that an insured owns two cars, a Ford and a Chevy, but only the Ford is covered by his automobile liability policy. The insured is in an accident while driving the Chevy. The claimant's pleadings allege that the insured was negligent in the operation of "an automobile." Under a strict application of the exclusive pleading and potentiality rules, the insurer would have a duty to defend because the ambiguous nature of the pleadings raises a potentiality of coverage. However, the insurer may look to the actual facts,

also use extrinsic evidence to determine its duty to defend when the complaint unequivocally shows coverage based on false allegations of a non-material fact.²⁷⁸

The use of extrinsic evidence to determine a duty to defend often arises when a driver of an automobile claims insured status as a permissive user under an omnibus clause of an automobile policy. Allegations that the driver was the agent, servant, or employee of the owner of the automobile raise the potentiality that the driver was using the automobile with the owner's permission, thus bringing the driver within the definition of an additional insured under the standard automobile policy. If the insurer is aware of facts that indicate that the driver was not a permissive user, the insurer is caught in a dilemma. The exclusive pleading rule demands that the insurer defend the putative insured, but the insurer knows that it does not have to defend a person who is a stranger to the contract between it and the named insured.²⁷⁹

Courts and commentators take different approaches to the problem of the putative insured.²⁸⁰ One group allows the insurer to consult extrinsic evidence to determine its duty to defend because the standard duty-to-defend provision does not obligate the insurer "to defend a com-

not the alleged facts, to determine its duty to defend, because the identity of the automobile is not material to the underlying tort action. See *Rowell v. Hodges*, 434 F.2d 926 (5th Cir. 1970); *Burd*, 56 N.J. at 388, 267 A.2d at 9; see also *Kepner v. Western Fire Ins. Co.*, 109 Ariz. 329, 509 P.2d 222 (1973) (insurer could determine its duty to defend based on actual facts when the complaint gave rise to a duty to defend but the actual facts showed that the insured was excluded from coverage under an automobile liability policy because of a business activity exclusion) (cited by *Rairigh*, 59 Md. App. at 322, 475 A.2d at 517). See generally A. WINDT, *supra* note 71, § 4.04.

278. In the example in the note above, the insurer would still be able to consult extrinsic evidence to determine its duty to defend even if the complaint had unambiguously but falsely alleged that the insured was operating the Ford (the covered automobile) at the time of the accident. An insurer would be prudent to assume the defense under a reservation of rights but then to institute a declaratory judgment action to determine its duty based on the extrinsic facts. See *Atlantic Mut. Fire Ins. Co. v. Cook*, 619 F.2d 553, 554-55 (5th Cir. 1980). The insurer's failure to offer a defense may constitute a breach of its duty. Cf. *Colon v. Aetna Life & Casualty Co.*, 66 N.Y.2d 6, 484 N.E.2d 1040, 494 N.Y.S.2d 688 (1985) (false allegation that driver was a permissive user of the insured owner's automobile gave rise to a duty to defend and subjected the breaching insurer to damages).
279. One commentator argues that the insurer should be allowed to consult extrinsic evidence to determine whether its duty to defend exists. While the pleadings may give rise to a duty to defend, the insurer has to defend allegations only if it has an actual duty to defend. The relationship of insurer and insured is a prerequisite to the insurer's obligations to defend and indemnify. Allowing the drafter of the claimant's pleadings to create the insurer-insured relationship would lead to absurd results. The driver is not an insured unless and until he can prove, as a matter of fact, that he qualifies as an additional insured. See A. WINDT, *supra* note 71, § 4.05, at 144-47.
280. See *Navajo Freight Lines v. Liberty Mut. Ins. Co.*, 12 Ariz. App. 424, 471 P.2d 309 (1970); *Auto-Owners Ins. Co. v. Jones*, 397 So. 2d 317 (Fla. Dist. Ct. App. 1981); A. WINDT, *supra* note 71, at § 4.05.

plete stranger to the contract."²⁸¹ The other group holds the insurer responsible for providing a defense to the putative insured but permits the insurer to bring a declaratory judgment action to determine its defense obligation.²⁸²

In Maryland, although no court has addressed the issue directly, it appears that an insurer would be allowed to consult extrinsic evidence to determine whether it owed a duty to defend the putative insured, because the issue of whether the driver was a permissive user is not material to the underlying tort action.²⁸³ Nevertheless, a prudent insurer should assume the defense under a reservation of rights and institute a declaratory judgment action to determine its defense duty, especially where there is a factual dispute over whether the driver had permission to use the insured owner's vehicle.²⁸⁴ Declaratory judgment is appropriate in these cases because the issue of permissive use is not material to the issue of either the driver's or the owner's tort liability.²⁸⁵

C. *The Duty to Defend and the Tort of Bad Faith*

In Maryland, an insurer is obligated to act fairly and in good faith in settling third-party liability claims within the policy limits.²⁸⁶ This obligation of fair dealing and good faith is a fiduciary duty that arises out of the insurer's exclusive control of the investigation, settlement and defense of the claim against its insured.²⁸⁷ The insurer's exclusive control over the litigation creates an actual or potential conflict of interest between insurer and insured.²⁸⁸ The insured wants to protect his personal assets by settling the case within the policy limits. The prospect of an award in excess of the insured's policy limits does not threaten the insurer, how-

281. A. WINDT, *supra* note 71, § 4.05, at 144.

282. See *Colon v. Aetna Life & Casualty Co.*, 66 N.Y.2d 6, 484 N.E.2d 1040, 494 N.Y.S.2d 688 (1985); *American Home Assurance Co. v. Czarnecki*, 255 La. 251, 230 So. 2d 253 (1970); *Lumbermen's Mut. Casualty Co. v. Rollings*, 355 So. 2d 1041 (La. Ct. App. 1978).

283. Cf. *Burd v. Sussex Mut. Ins. Co.*, 56 N.J. 383, 267 A.2d 7 (1970) (cited with approval in *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App 305, 317, 475 A.2d 509, 516, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984)).

284. In the likely event that the claimant sues both the driver and the insured owner, the insurer would have an obligation to defend both. The insurer would also have to offer the driver his *Brohawn* choice of counsel. It would be best, however, if the insurer engaged separate counsel to represent the driver and the owner. The owner's attorney would move quickly to rebut the presumption of agency and, if possible, would seek summary judgment. At the same time, the insurer could institute a declaratory judgment action to determine whether the driver was using the automobile with the owner's permission.

285. *McCarty v. Parks*, 564 P.2d 1122 (Utah 1977). But see *Murphy v. Urso*, 88 Ill.2d 444, 430 N.E.2d 1079 (1981) (issue of permissive use so intertwined with concept of agency that declaratory judgment was not appropriate).

286. *State Farm Mut. Auto. Ins. Co. v. White*, 248 Md. 324, 236 A.2d 269 (1967); *Sweeten v. National Mut. Ins. Co.*, 233 Md. 52, 194 A.2d 817 (1963).

287. *Sweeten*, 233 Md. at 55, 194 A.2d at 818.

288. *Id.* This conflict of interest, however, does not give rise to a *Brohawn* choice of independent counsel because the conflict does not involve the conduct of the case.

ever, so the insurer is less motivated to settle the claim within policy limits.²⁸⁹

The duty to act fairly and in good faith requires the insurer to give equal weight to its own interests and those of the insured.²⁹⁰ The insurer must act honestly, exercise reasonable care, diligently investigate and appraise the case, and keep its insured reasonably well-informed of the progress of the case, including settlement offers.²⁹¹ Although the good faith standard requires the insurer to act honestly and diligently, it does not impose liability upon the insurer for simple negligence.²⁹² Serious and recurrent negligence, however, may be evidence of bad faith.²⁹³ Many factors may affect whether an insurer's decision not to settle was an honest and informed one that took the insured's interests into account.²⁹⁴ If an insurer acts in bad faith by not settling a third-party claim within policy limits, then it is liable for any verdict in excess of the policy limits.²⁹⁵

Maryland courts have limited the scope of the tort of bad faith to the insurer's duty to settle and have expressly refused to expand the tort to situations involving an insurer's bad faith failure to pay an insurance claim.²⁹⁶ The Maryland courts, however, have not decided whether the

289. *Johnson v. Federal Kemper Ins. Co.*, 74 Md. App. 243, 247, 536 A.2d 1211, 1213, *cert. denied*, 313 Md. 8, 542 A.2d 844 (1988).

290. *Sobus v. Lumbermen's Mut. Cas. Co.*, 393 F. Supp. 661 (D. Md. 1975) (applying Maryland law). The concept of "good faith" is a "highly elusive one." *Id.* at 672.

291. *State Farm Mut. Auto. Ins. Co. v. White*, 248 Md. 324, 332, 236 A.2d 269, 273 (1967).

292. *Sobus*, 393 F. Supp. at 673. An insurer also has a separate tort duty to "conduct the actual defense of the insured with reasonable care. . . ." *Id.* at 671. Among other things, this duty requires the insurer to conduct an adequate investigation. If the insurer breaches its duty of reasonable care in preparing and conducting the defense, then it "is liable for a verdict adverse to its insured in excess of the policy limits, which is caused by the insurer's negligence." *Id.* See generally 1A R. LONG & M. RHODES, *supra* note 67, § 5.26; A. WINDT, *supra* note 71, § 4.38.

293. *Sobus*, 393 F. Supp. at 673.

294. Among the factors that a court will consider in determining whether an insurer breached its obligation to use good faith in settling a claim within its insured's policy limits are:

[T]he severity of the plaintiff's injuries giving rise to the likelihood of a verdict greatly in excess of the policy limits; lack of proper and adequate investigation of the circumstances surrounding the accident; . . . failure of the insurer to inform the insured of a compromise offer within or near the policy limits; pressure by the insurer on the insured to make a contribution towards a compromise settlement within the policy limits, as an inducement to settlement by the insurer; and actions which demonstrate a greater concern for the insurer's monetary interests than the financial risk attendant to the insured's predicament.

White, 248 Md. at 332, 236 A.2d at 273. A "mere mistake of judgment" will not impose liability on the insurer. *Sobus*, 393 F. Supp. at 673 (quoting *American Casualty Co. v. Howard*, 187 F.2d 322, 329 (4th Cir. 1951)). The issue of whether the insurer acted in good faith is a factual one. *Schlossberg v. Epstein*, 73 Md. App. 415, 436, 534 A.2d 1003, 1014 (1988).

295. See, e.g., *White*, 248 Md. at 330-31, 236 A.2d at 272.

296. *Johnson v. Federal Kemper Ins. Co.*, 74 Md. App. 243, 246, 536 A.2d 1211, 1212,

tort should be extended to the duty to defend.²⁹⁷ While there are arguments to the contrary,²⁹⁸ the extension seems both logical and inevitable, especially in light of the related obligations of reasonable care and good faith imposed on the insurer.²⁹⁹

Several jurisdictions have recognized that a bad faith refusal to defend may constitute a breach of the insurer's duty of fair dealing and good faith.³⁰⁰ In such jurisdictions, the mere refusal to defend does not in itself constitute bad faith. While the insured need not show that the insurer acted with malice, oppression, or fraud, he must show more than the mere breach of the contractual duty to defend.³⁰¹ An insurer's failure to conduct an investigation into its duty to defend, coupled with its failure to consider the opinions of its own staff regarding its duty to defend, has been held to constitute sufficient proof of bad faith.³⁰² But if the insurer has reasonable grounds for refusing to defend its insured, then no tort liability will attach.³⁰³

The extension of the tort of bad faith to the duty to defend opens the door to the recovery of damages beyond those available in traditional breach of contract suits. In a breach of contract action based on an insurer's refusal to defend, the insured is entitled to reasonable attorney's fees and expenses incurred in the underlying tort suit and in any declaratory judgment action brought against the insurer to determine cover-

cert. denied, 313 Md. 8, 542 A.2d 844 (1988); *Caruso v. Republic Ins. Co.*, 558 F. Supp. 430 (D. Md. 1983) (applying Maryland law).

297. In *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 317, 475 A.2d 509, 514-15, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984), however, the trial court assumed that the tort of bad faith did exist and even awarded the insured punitive damages. On appeal, the court did not address the validity of a bad faith claim based on an insurer's refusal to defend its insured. *But see* *Dickson v. Selected Risks Ins. Co.*, 666 F. Supp. 80, 81 (D. Md. 1987) (applying Maryland law) (excess insurer's refusal to defend does not give rise to a claim based on "bad faith;" rather the insurer's breach is "fully remedial by a contract action.").

298. The duty to act in good faith is inherent in every contract. *Caruso*, 558 F. Supp. 430; *Johnson*, 74 Md. App. 243, 536 A.2d 1211. The tort of bad faith arises from breach of the fiduciary duty owed to the insured by the insurer because the insurer's total control of the case creates a potential conflict of interest. *See supra* text accompanying notes 287-289. But there is no need to impose a separate tort duty on the insurer to act in good faith in honoring its duty to defend, because there is no potential for a conflict of interest to arise. In other words, there is no fiduciary duty owed because the fiduciary duty is not undertaken. *See* *Farris v. United States Fidelity & Guar. Co.*, 284 Or. 453, 587 P.2d 1015 (1978).

299. Indeed, one commentator has even stated that "there appears no valid reason why a liability insurer that refuses in bad faith to defend its insured against a third-party action should not also be subject to tort liability for breach of the implied covenant of good faith and fair dealing." M. SHERNOFF, S. GAGE, & H. LEVINE, *INSURANCE BAD FAITH LITIGATION* § 3.25[1] (1987) [hereinafter M. SHERNOFF].

300. *Id.*

301. *Id.* ("To recover on a tort theory for breach of the implied covenant of good faith, it appears that the insured must establish more than a breach of the contractual duty to defend.").

302. *See* *Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370, 1375 (9th Cir. 1985).

303. *See* *American Excess Ins. Co. v. M.G.M. Grand Hotels, Inc.*, 729 P.2d 1352, 1354-55 (Nev. 1986); *Calenda v. Allstate Ins. Co.*, 518 A.2d 624, 629 (R.I. 1986).

age.³⁰⁴ In those jurisdictions that recognize the tort of bad faith in the duty to defend context, an insured is entitled to recover damages for emotional distress, and under certain circumstances, punitive damages, in addition to the amount of any judgment in excess of his policy limits.³⁰⁵ If Maryland courts were to extend the tort of bad faith to the duty to defend, it is likely that both damages for emotional distress³⁰⁶ and, upon a showing of actual malice, punitive damages³⁰⁷ could be recovered.

VIII. CONCLUSION

In Maryland, the standard liability policy requires the insurer to defend the insured against any suit alleging a claim that falls within the scope of the policy's coverage. In addition, the insurer is required to defend the insured against any suit alleging a claim that does not fall clearly within the scope of the policy's coverage if there is a potential that the claim may be covered. The insurer's obligation to defend claims that raise a potential duty to indemnify gives the insured the litigation protection he purchased and is one of the most important benefits in the standard liability policy.

In recent years, Maryland courts have broadened the insurer's obligations to a point where the insurer has a near-absolute duty to defend whenever its insured is sued. An insurer is obligated to defend its insured unless it can be concluded as a matter of law that no factual or legal basis exists on which the insurer may be held liable under its duty to indemnify.

The imposition of a near-absolute duty to defend has several consequences: it places the burden on the insurer to bring a declaratory judgment action to determine its obligation if the insurer disputes such an obligation, it fulfills the insured's reasonable expectations and it protects the insured from the insurer's mistakes of judgment in evaluating its duty to defend. The basic rule has been expanded in some jurisdictions by applying the tort of bad faith to the insurer's duty to defend and by imposing a defense duty under the factual exception to the exclusive pleading rule. Although these extensions of the duty have not yet been

304. See *supra* notes 119-123 and accompanying text.

305. See generally A. WINDT, *supra* note 71, § 4.34, at 210-11; M. SHERNOFF, *supra* note 299, § 3.26[2]; Annotation, *Insurer's Tort Liability for Consequential or Punitive Damages for Wrongful Failure or Refusal to Defend Insured*, 20 A.L.R.4TH 23 (1984).

306. For a general consideration of damages for emotional distress, see Annotation, *Emotional or Mental Distress as Element of Damages for Liability Insurer's Wrongful Refusal to Settle*, 57 A.L.R.4TH 801 (1988).

307. See *H. & R. Block, Inc. v. Testerman*, 275 Md. 36, 338 A.2d 48 (1974) (punitive damages awarded in torts arising out of a breach of contract upon a showing of actual malice); cf. *Fireman's Fund Ins. Co. v. Rairigh*, 59 Md. App. 305, 311-12, 475 A.2d 509, 512, *cert. denied*, 301 Md. 176, 482 A.2d 502 (1984) (trial court granted punitive damages for a bad faith refusal to defend, but the appellate court did not address either the availability or the standard for awarding such damages).

adopted in Maryland, they further the reasonable expectations of the insured and comport with Maryland public policy. The burden of the insurer's duty to defend is heavy, but it is a burden the insurer, as the drafter of the policy, has chosen to bear.