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Termination of the Duty of an Insurance Carrier to Defend: Did the California Supreme Court send the wrong Signal?

An insurance carrier has a contractual duty to indemnify an insured for losses covered by the insurance policy. Under most policies of liability insurance, this duty is accompanied by a correlative duty of the insurance carrier to defend the insured against all actions brought against the insured that arise out of the circumstances covered by the insurance policy. The duty to defend includes the duty to provide a defense and the duty to pay defense costs. Many insureds are unaware that a duty to defend is included in their insurance coverage. Although most insureds consider the duty of indemnification far more important than the duty of the insurance carrier to defend a potential lawsuit, the obligation to defend is growing more important. The increasing recognition of the duty to defend is in part due to the escalating cost of litigation and the increase in the amount of awards.

Many courts and commentators have evaluated the general principles of the duty to defend. The issue of when the duty to defend terminates, however, has not been the subject of extensive review.

1. The person who undertakes to indemnify another by insurance is the insurer or insurance carrier, and the person indemnified is the insured. Cal. Ins. Code §23.
4. Cal. Ins. Code §108 provides: "Liability insurance includes . . . [i]nsurance against loss resulting from liability for injury, fatal or nonfatal, suffered by any natural person, or resulting from liability for damage to property, or property interests of others." Id.
7. Id.
8. Id. With the insurance carrier paying the defense costs, the economic obstacles to defending an action vigorously vanish. Id.
10. See infra notes 64-106 and accompanying text.
11. See infra notes 118-71 and accompanying text; but see German & Gallagher, supra note 9, at 245.
issue of when the duty to defend terminates can be illustrated by referring to an Illinois case, *Denham v. LaSalle-Madison Hotel Company*. In 1946, the LaSalle-Madison Hotel Company carried $10,000 worth of liability insurance for the damage to, or loss of, the property of any guest or invitee of the hotel. A fire occurred in which the property of approximately 250 guests was damaged by fire, smoke, or water. The insurance carrier indemnified the hotel for $10,000, thereby exhausting the limits of the policy. This amount, however, did not compensate all of the potential plaintiffs. Naturally, the uncompensated parties subsequently attempted to be compensated for their losses.

The insurance carrier could not be required to pay beyond the policy limits because the hotel insured against a limited amount of risk, namely $10,000. Due to the fact that the policy limit was exhausted, the insurance carrier was not required under the contract to pay any additional money. Whether the insurance carrier still has a duty to defend after payment of the policy amount, however, is unclear. A split of authority exists among jurisdictions on the proper rule to apply. Some courts have held that the insurance carrier may not be absolved of the duty to defend by tendering the policy limits. Other courts, including the court in *Denham*, however, have held that the insurance carrier does not have a duty to defend upon payment of the policy limits. In this comment, the author will analyze and critique California law regarding the duty of an insurance carrier to defend the insured after the insurance carrier has fulfilled the indemnification required under the policy. This author contends that the

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12. 168 F.2d 576 (7th Cir. 1948), cert. denied, 335 U.S. 871 (1948).
13. *Id.* at 577.
14. *Id.* at 576.
15. *Id.* at 584.
16. *Id.*
17. *Id.*
18. *Id.* at 584; see also Keeton, *supra* note 3, at 2.
21. See infra notes 118-22 and accompanying text.
22. *Denham*, 168 F.2d at 584.
23. See infra notes 123-26 and accompanying text.
24. See infra notes 127-71 and accompanying text.
duty to defend must be linked to the duty to indemnify so that the duty terminates upon payment to the insured of the policy limits.25

To resolve the problem of when the duty to defend terminates, a consideration of several aspects of basic insurance law is necessary. An analysis of the specific language of the various insurance policies first will be given.26 This author then will discuss the many rules of interpretation to which the language of the insurance policy is subject.27 After an examination of the insurance policy, the procedure of the duty to defend will be outlined.28 This author will demonstrate the difficulties that an insurance carrier encounters in determining if the duty to defend commences in a particular action.29 In California, an insurance carrier is obligated to defend an insured from an action if any alleged claim potentially is within the coverage of the policy.30

The use of a reservation of rights agreement also will be explored.31 A reservation of rights agreement enables an insurance carrier to defend a third party action brought against the insured without admitting to the insured liability for the underlying claim.32 The standard of care that an insurance carrier must use when defending an insured also will be explained.33 Additionally, an overview of “layered” insurance coverage and the impact that layered insurance has on the duty to defend will be given.34 Briefly, “layered” coverage describes insurance in which an insured obtains several types of liability coverage for the same risk, sometimes with different insurance carriers.35 An examination of layered coverage is critical because California courts have analyzed the termination of the duty to defend almost without exception in layered coverage cases.36 The problem arises in this situation because the indemnification and defense duties of one insurance carrier arguably exist only after the exhaustion of the duties of the other insurance carrier.37

25. See infra notes 172-90 and accompanying text.
26. See infra notes 44-50 and accompanying text.
27. See infra notes 51-63 and accompanying text.
28. See infra notes 64-106 and accompanying text.
29. See infra notes 64-96 and accompanying text.
30. See infra notes 73-96 and accompanying text.
31. See infra notes 97-101 and accompanying text.
32. See infra notes 99-101 and accompanying text.
33. See infra notes 102-05 and accompanying text.
34. See infra notes 107-17 and accompanying text.
35. See infra notes 107-13 and accompanying text.
37. See infra notes 114-17 and accompanying text.
After discussing principles of insurance law, this author will examine California case law concerning the duty to defend in the indemnity context. California courts have not developed a clear rule to determine whether the duty to defend ends after indemnification. Rather, the courts have analyzed various factors, including the specific language of the insurance policy, the relationship between the insurance carrier and the insured, and the nature of the injury giving rise to the claim. The inconsistencies in the California approach to the problem of the relation between the duty to defend and the duty to indemnify will be highlighted. This author recommends that California courts should declare the duty to defend linked to the duty to indemnify so that the duty terminates upon payment to the insured of the policy limits. Then, by applying principles of equitable subrogation, the effectiveness of this proposal will be demonstrated in the context of layered insurance coverage. As a preliminary matter, however, a consideration of the construction of insurance contracts is necessary.

**CONSTRUCTION OF INSURANCE CONTRACTS**

Since the duty of an insurance carrier to defend the insured arises out of the insurance contract, the key to determining the extent of the duty to defend lies in the interpretation of the wording of the insurance contract. The basic rule in the interpretation of insurance contracts is that the policy should be given a plain and ordinary meaning. Thus, if the contract language is clear, a court should not give the language a strained construction that would impose upon the insurance carrier a liability that the carrier has not assumed.

A duty to defend clause, therefore, can be limited expressly so

38. See infra notes 127-71 and accompanying text.
39. See infr notes 174-77 and accompanying text.
40. See infra notes 142-46 and accompanying text.
41. See infra notes 172-90 and accompanying text.
42. See infra notes 172-205 and accompanying text.
43. See infra notes 191-205 and accompanying text.
44. In California, the duty to defend may be implied by the court under special circumstances. See infra notes 71-73 and accompanying text.
45. Montgomery, supra note 19, at 652.
47. Id. at 218, 169 Cal. Rptr. at 280-81.
48. The standard form liability policy, prior to a revision in 1955, contained an insurance agreement set forth separately in the policy and headed “Defense, Settlement, Supplementary Payments.” See Montgomery, supra note 19, at 657. In the early history of liability insurance, some policies clearly gave the carrier a three-way option of defending, settling, or paying the insured the face amount. R. Keeton, supra note 3, §7.6 at 481. The 1966 and subsequent revisions
that the duty to defend will end when the policy limits are exhausted.\textsuperscript{49} Both the language and interpretation of clauses that limit the duty to defend generally are unclear, however, and thus do not necessarily dictate the point at which the duty to defend ceases.\textsuperscript{50} With this point in mind, some basic rules on the interpretation of insurance policies can be explored.

Elementary insurance law requires that any ambiguity or uncertainty in an insurance policy be resolved against the insurance carrier.\textsuperscript{51} This rule has arisen to help overcome the inherent inequality in bargaining power between the insurance carrier, who drafts the policy, and the insured, who typically accepts the terms of the policy without alteration.\textsuperscript{52} Therefore, if a defense clause does not state expressly that the duty of the insurance carrier to defend ends when the policy limits are reached or if the clause is otherwise unclear on this point, the uncertainty will be resolved against the insurance carrier.\textsuperscript{53} For example, in an attempt to limit the duty to defend solely to the indemnification limits, many liability policies provide that the duty to defend will apply to "such insurance as afforded by the policy."\textsuperscript{54} "Such insurance" is ambiguous because the language could refer to the type of insurance or to the combination of the type and amount of the insurance.\textsuperscript{55} In this situation, a court can construe "such insurance" to refer to the type of insurance only, resolving the ambiguity in favor of the insured, thus requiring the insurance carrier to defend beyond the policy amounts.\textsuperscript{56}

Along with the certainty requirement, the insured is protected by the doctrine of reasonable expectations.\textsuperscript{57} This doctrine provides that the reasonable expectations of the insured regarding the insurance

\textsuperscript{49} A. Windt, \textit{supra} note 20, at 161.
\textsuperscript{50} See \textit{infra} notes 129-71 and accompanying text.
\textsuperscript{52} King, Zeavin & Snyder, \textit{supra} note 5, at 175.
\textsuperscript{53} A. Windt, \textit{supra} note 20, at 161.
\textsuperscript{54} Id; see \textit{infra} notes 129-48 and accompanying text (example of a California case).
\textsuperscript{55} A. Windt, \textit{supra} note 20, at 161.
\textsuperscript{56} See \textit{id}.
\textsuperscript{57} King, Zeavin & Snyder, \textit{supra} note 5, at 176; R. Keeton, \textit{supra} note 3, \$6.3 at 351.
policy will be honored even though study by the insured of the policy provisions would have negated those expectations.\textsuperscript{58} The California Supreme Court in \textit{Gray v. Zurich Insurance Company}\textsuperscript{59} expanded the doctrine of reasonable expectations to include the duty to defend.\textsuperscript{60} \textit{Gray} recognized that the insurance contract in question was entered into by parties of unequal bargaining strength and was offered to the insured on a “take it or leave it” basis.\textsuperscript{61} The insurance carrier in \textit{Gray} made two broad promises in the policy: (1) to pay all sums that the insured became legally obligated to pay because of bodily injury or property damage; and (2) to defend any suit against the insured alleging bodily injury or property damage even if the allegations of the suit were groundless, false, or fraudulent.\textsuperscript{62} \textit{Gray} held that this broad language of the defense provision may have led the insured reasonably to expect that the insurance carrier would provide a defense of all suits brought against the insured, despite a provision in the policy excluding the duty to defend for intentional misconduct.\textsuperscript{63}

Thus, in addition to the familiar contract defenses, an insured is protected by strict construction of the insurance policy against the insurance carrier and the doctrine of reasonable expectations. Using these concepts, a court may find that an insurance carrier has a duty to defend the insured despite language in the insurance contract to the contrary. Before discussing the extent of this duty to defend, a brief analysis of the procedure involved in the duty to defend is appropriate.

\textbf{THE DUTY TO DEFEND}

Since the insurance carrier ultimately may be liable for losses suffered by the insured, the carrier has a strong economic interest in controlling lawsuits brought against the insured.\textsuperscript{64} Thus, most liability insurance policies provide that an insurance carrier has both the right and duty to defend the insured.\textsuperscript{65} In most jurisdictions, however, if no contract

\begin{itemize}
  \item \textsuperscript{58} Keeton, \textit{supra} note 3, \S 6.3 at 351.
  \item \textsuperscript{59} 65 Cal. 2d 263, 419 P.2d 168, 54 Cal. Rptr. 104 (1966).
  \item \textsuperscript{60} \textit{Id.} at 268-70, 419 P.2d at 171, 54 Cal. Rptr. at 107-108.
  \item \textsuperscript{61} \textit{Id.} at 269, 419 P.2d at 171, 54 Cal. Rptr. at 107; Revere & Chapman, \textit{supra} note 5, at 893.
  \item \textsuperscript{62} \textit{Gray}, 65 Cal. 2d at 272-73, 419 P.2d at 173-74, 54 Cal. Rptr. at 109-10.
  \item \textsuperscript{63} \textit{Id.} at 272, 419 P.2d at 173, 54 Cal. Rptr. at 109; \textit{See} King, Zeavin & Snyder, \textit{supra} note 5, at 176. The insurance policy in \textit{Gray} did not cover intentional torts; \textit{see infra} notes 77-96 and accompanying text.
  \item \textsuperscript{64} King, Zeavin & Snyder, \textit{supra} note 5, at 173.
  \item \textsuperscript{65} A. Windt, \textit{supra} note 20, at 101.
\end{itemize}
to defend exists, no concomitant duty to defend arises. But, in the unlikely event the insurance policy is silent on the subject, the duty to defend in California will arise by statute. California Civil Code section 2778 provides that indemnity against liability embraces the costs of defense against claims brought against the insured. Hence, if the parties are under a contract of indemnity, a statutory duty arises requiring the insurance carrier to defend the insured.

California courts will imply a duty to defend even though the duty may be excluded expressly from the insurance policy. In 1976, the California Court of Appeal for the Second District implied the duty to defend in an insurance contract by invoking the reasonable expectations doctrine. The court found that because of the unclear language in the contract concerning the duty to defend, the insured reasonably expected that the insurance carrier would provide a defense. Thus, the court was willing to imply the duty to defend even though the defense clause arguably excluded the duty. Since the duty to defend is included or implied in nearly all liability contracts, the next issue this author will consider is the nature of that duty. Initially, the question of when the duty of defense arises will be considered.

In the landmark case of Gray v. Zurich Insurance Company, the California Supreme Court examined the duty to defend and rejected the rule adopted by many states. Under the rule applied by those states, an insurance carrier is not required to defend actions that, as alleged in the complaint, are not covered by the insurance policy. The Gray court, however, increased the burden on the insurance carrier by holding that the insurance carrier is obligated to defend an action if the claim alleged potentially is within the coverage of the insurance policy.

66. Id. at 101 n.1.
67. CAL. CIV. CODE §2778(3)-(5); see King, Zeavin & Snyder, supra note 5, at 174.
68. CAL. CIV. CODE §2778(3)-(5). This code section, however, often has been overlooked by practicing attorneys. King, Zeavin & Snyder, supra note 5, at 174.
69. The statutory duty exists only if an indemnity agreement gives rise to liability and does not apply to a party that is held liable under noncontractual indemnity principles. See Davis v. Air. Tech. Indus., Inc., 22 Cal. 3d 1, 6 n.6, 582 P.2d 1010, 1013 n.6, 148 Cal. Rptr. 419, 422 n.6 (1978).
70. King, Zeavin & Snyder, supra note 5, at 174.
71. E.g., Aetna, 56 Cal. App. 3d at 800, 129 Cal. Rptr. at 52-53.
72. Id. at 800, 129 Cal. Rptr. at 53.
73. Id.
74. Gray, 65 Cal. 2d at 268-81, 419 P.2d at 171-79, 54 Cal. Rptr. at 107-15; see Revere & Chapman, supra note 5, at 892.
75. Gray, 65 Cal. 2d at 275, 419 P.2d at 176, 54 Cal. Rptr. at 112.
76. Id. at 275, 419 P.2d at 176, 54 Cal. Rptr. at 112.
Gray involved an action by an insured against his insurance carrier for failure to defend the insured from an assault complaint. 77 The policy issued by the insurance carrier was a "Comprehensive Personal Liability Endorsement" containing not only a defense clause but also a clause excluding intentional tort coverage from the insurance contract. 78 The initial suit arose out of a fight between Gray, the defendant, and Jones, the plaintiff. 79 Jones filed a complaint alleging that Gray "willfully, maliciously, brutally and intentionally assaulted" him. 80 Gray notified his insurance carrier of the suit, stating that he had acted in self-defense, and asked the insurance carrier to defend. 81 The insurance carrier refused, stating that the complaint alleged an intentional tort, which was an action outside the coverage of the policy. 82 Gray then defended unsuccessfully on the theory of self-defense. 83

The court in Gray first noted that the insurance policy set forth a duty to defend. 84 The court then found that the insurance carrier had attempted to avoid the policy by employing unclear policy language that exempted coverage for intentional torts. 85 Invoking the reasonable expectation rule, the court found that the insured reasonably could expect, and was legally entitled to, defense protection. 86 Gray held that the insurance carrier must defend any suit in which a plaintiff seeks damages potentially within coverage of the policy. 87 The action by Jones was such a suit because that action, although alleging damages from intentionally inflicted injuries, potentially could be decided under negligence theories and thus be within policy coverage. 88

The general rule to determine defense coverage under an insurance policy, however, is that the specific allegations of the complaint control. 89 Hence, had the Gray court followed the majority rule, the insurance carrier would have had no duty to defend because Jones’

77. Id. at 266, 419 P.2d at 169, 54 Cal. Rptr. at 105.
78. Id. at 267, 419 P.2d at 170, 54 Cal. Rptr. at 106.
79. Id.
80. Id.
81. Id.
82. Id.
83. Id. Jones was awarded a judgment of $6,000 in actual damages. Id. The jury refused, however, to award the requested punitive damages. Id.
84. Id. at 268, 419 P.2d at 171, 54 Cal. Rptr. at 107.
85. Id.
86. Id.
87. Id. at 275, 419 P.2d at 176, 54 Cal. Rptr. at 112.
88. Id. at 276, 419 P.2d at 176, 54 Cal. Rptr. at 112.
89. King, Zeavin & Snyder, supra note 5, at 175.
complaint alleged an intentional act, which was not covered by the contract. To allow the defense obligation of the insurance carrier to be determined by the precise language of the pleading, the Gray court claimed, would create an anomaly for the insured. To avoid bringing the insurance carrier into the litigation, the third party complaint could have drafted a pleading to allege injury or damage not covered by the insured’s policy. For example, a third party may allege an intentional tort, such as battery, knowing that if the true cause of action, negligence, were pleaded, the insurance carrier will step in to defend. Considering the likely overstatement in the complaint and the liberality of modern pleading, the Gray court held that the third party hardly should be the “arbiter” of coverage under the policy. Therefore, held that the duty to defend may arise even though the complaint against the insured alleges damages not within the policy coverage. Additionally, the Gray court syllogized that since no one can determine at the outset of trial whether the third party suit falls within the indemnification coverage of the policy, the issue of whether the claim alleged is within the coverage of the policy, invoking the duty to defend and indemnify, will not be resolved until after adjudication of the action. Thus, if an insurance carrier finds that the injury caused by the insured has the potential to fall within policy coverage despite allegations in the complaint to the contrary, then the insurance carrier is obliged to defend. Having explored the circumstances that invoke the duty to defend, this author now will discuss

90. Gray, 65 Cal. 2d 276, 419 P.2d at 176, 54 Cal. Rptr. at 112.
91. Id. The third party may or may not desire the insurance carrier to be involved in the litigation. See e.g., Taylor v. Superior Court, 24 Cal. 3d 890, 904-05, 598 P.2d 854, 862, 157 Cal. Rptr. 693, 702 (1979) (Clark, J., dissenting). If the third party brings in the insurance carrier, the third party brings in the “deep pockets.” See id. On the other hand, if the third party does not involve the carrier in the litigation, the third party is left to the insured’s assets and not the policy proceeds. See id. In Taylor, Judge Clark stated that when punitive damages are awarded, the insurance carrier would be absolved of all liability. Id. Thus, plaintiff would have a large award, but would be left with nobody to pay the award and hence would rarely ask for punitive damages. Id.
92. Gray, 65 Cal. 2d at 276, 419 P.2d at 176, 54 Cal. Rptr. at 112.
93. Id.
94. Id. at 276-77, 419 P.2d at 176-77, 54 Cal. Rptr. at 112-13.
95. Id. at 271-72, 419 P.2d at 175, 54 Cal. Rptr. at 109; see Centennial Ins. Co. v. Applied Health Care Systems, 710 F.2d 1288, 1291 (7th Cir. 1983).
96. See Mullen v. Glen Falls Ins. Co., 73 Cal. App. 3d 163, 170, 140 Cal. Rptr. 605, 609 (1977) (the court examined whether the insurance carrier possessed sufficient factual information to determine whether the duty to defend arose). A wrongful refusal to defend by an insurance carrier automatically will subject the carrier to liability for both the costs of defense and any adverse judgment the insured suffers, even when the judgment is rendered on a theory not within coverage of the insurance policy. Cathay Mortuary (Wah Sang) v. United Pac. Ins., 582 F. Supp. 650, 659-60 (N.D. Cal. 1984).
the reservation of rights agreement, a device used by insurance carriers to limit their liability if the duty to defend has been invoked.

If the insurance carrier assumes the defense of an action against the insured, the carrier is estopped from a defense of noncoverage in any subsequent litigation by the insured against the insurance carrier. To prevent estoppel, the insurance carrier can accept the defense of an action brought against the insured while reserving the right to contest the indemnification issues. In California, because the duty to defend is invoked upon the potential of liability, the reservation of rights agreement often is used to prevent estoppel. The use of a reservation of rights agreement coupled with the rule in Gray, however, creates a potential for nonzealous defense by the insurance carrier. Before Gray the insurance carrier only would have to defend the insured from actions in which the insurance carrier had a predictable interest. Under the Gray rule, and with the advent of estoppel-preventing agreements, an insurance carrier may be required to defend an action for which the insurance carrier ultimately will not be liable. Hence, the possibility of a less than competent defense by the insurance carrier is present. Courts have responded to this dilemma by requiring a good faith defense by the insurance carrier. Thus, in fulfilling the duty to defend, the insurance carrier is required to use due care and good faith.

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97. See Tomerlin v. Canadian Indem. Co., 61 Cal. 2d 638, 648, 394 P.2d 571, 577, 39 Cal. Rptr. 731, 737 (1964). In California, the theory that, by defending a suit, an insurance carrier waives the right to claim noncoverage rests upon the doctrine of estoppel. Val's Painting & Drywall, Inc. v. Allstate Ins. Co., 53 Cal. App. 3d 576, 587, 126 Cal. Rptr. 267, 273 (1976). Hence to prove a waiver of the right to claim noncoverage, the insured must show that the insurance carrier either intentionally relinquished a known right or acted in a manner that caused the insured reasonably to believe the carrier had relinquished the right, and that the insured relied upon the conduct of the carrier to the detriment of the insured. Id.

98. King, Zeavin & Snyder, supra note 5, at 177.

99. Id.

100. E.g., Aetna Cas. & Sur. Co. v. Richmond, 76 Cal. App. 3d 645, 143 Cal. Rptr. 75 (1977) (Richmond is a different case than the Aetna case discussed infra). In Richmond, for example, the reservation of rights agreement stated:

This Company will provide a defense for you as per the terms of the insurance policy, but this Company does not waive any of its Rights under the terms, conditions and provisions of the insurance policy. Therefore, if a judgment is entered against you for damages that are not covered under the policy this Company will not be responsible for the judgment.

Id. at 649-50, 143 Cal. Rptr. at 79; G. Couch, supra note 20, §51.78 at 565-66.


meet this standard, the carrier will be liable to the insured for the amount of the judgment in excess of the policy limits of the insured.103 When doubt exists whether the insured is covered under the insurance policy, the defense counsel provided by the insurance carrier is in an anomalous position because the defense counsel must protect the interests of both the insurance carrier and the insured. Although frequently the interests of the insured and the insurance carrier are the same, this anomaly arises when the interests conflict. For example, the insured may want the court to find the insured negligent, thereby requiring indemnification by the insurance carrier. On the other hand, the carrier may want the court to find the insured guilty of an intentional tort, thereby excluding indemnification.104 The defense counsel usually will withdraw from representing one of the parties in the event of conflicting interests of this type.105

An overview of the procedural aspects of the duty to defend has shown that the duty is contractual, although unique rules of construction apply. In California, the insurance carrier is obligated to defend the insured from any action potentially within the coverage of the insurance policy. The defense counsel involved in a situation embracing interests of both the insured and the insurance carrier can use a reservation of rights agreement to protect the future rights of the insurance carrier. The defense counsel must use the utmost due care and good faith in the defense of the insured.

The issue of when the duty to defend terminates now may be analyzed. Most cases in California that have addressed whether the duty to defend extends beyond indemnification involved “layered” insurance coverage.106 Thus, a review of the law concerning layered insurance coverage is necessary.

THE DUTY TO DEFEND IN THE CONTEXT OF LAYERED INSURANCE COVERAGE

Layered insurance coverage describes a situation in which an insured obtains several kinds of liability coverage for the same risk, usually at different rates.107 The underlying policy is called the “primary”

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103. J. Appleman, supra note 20, §46.87 at 179.
104. Magarick, supra note 5, §3.01 at 45-46.
105. Id. §3.05 at 51.
106. See supra note 36 and accompanying text.
policy. In Denham, the hotel fire case discussed earlier, the $10,000 coverage would be the primary coverage. If, however, the hotel owners wanted coverage beyond the $10,000 of primary coverage, they could obtain an "excess" liability policy. Under an excess insurance policy, the insurance carrier is not liable for any part of the loss that is covered by the primary insurance carrier. Rather, the excess carrier is liable only for the amount of loss in excess of the coverage provided by the other policy of insurance. A conflict between primary and excess insurance carriers arises in the determination of which carrier will pay for the costs of defending their mutual insured. The problem typically arises when the primary carrier is notified of a massive claim against the insured that will be very expensive to defend and, if successful, will exhaust the limits of the primary policy.

Several principles can be derived from California case law concerning the allocation of duties to defend between primary and excess insurers. Generally, the primary insurer has the primary duty to defend and the duty of the excess insurer is dependent upon the extent of the insured's claim. Thus, if the damages prayed for in the claim against the insured are less than the limits of the primary policy, and the primary insurer undertakes the defense, the secondary insurer is not required to defend. If the claim exceeds the limits of the primary policy, however, and only one insurer undertakes the defense, both insurers will be liable for a share of the costs of defense based upon the amount of the claim each is required to pay.

A brief examination of California law on the duty to defend by multiple insurers of the same risk has been provided. The duty to defend exists in nearly all liability policies and the approach of California courts obligates the insurance carrier to defend any action potentially within the terms of the policy. The point at which this duty

108. G. Couch, supra note 20, §62.48 at 484.
109. See supra notes 12-19 and accompanying text.
110. G. Couch, supra note 20, §62.46 at 484.
111. Id.
113. Id.
115. See Aetna, 56 Cal. App. 3d at 802, 129 Cal. Rptr. at 54; P. Magarick, supra note 5, §1.06 at 20-21.
116. See Aetna, 56 Cal. App. 3d at 802, 129 Cal. Rptr. at 54.
117. Id. Each share is based upon the ratio of the amount paid by each insurance carrier to the total amount paid by all carriers in the settlement of claims and the satisfaction of judgments. Id. at 802-3, 129 Cal. Rptr. at 54.
of defense terminates, however, is not clear. Thus, this comment next will explore the relevant case law concerning the duty to defend after the indemnification limits of the liability policy have been reached.

**Termination of the Duty to Defend—Applicable Case Law**

A sharp division exists among jurisdictions over whether the duty to defend terminates upon exhaustion of the indemnity limits of the insurance policy. On one hand, courts have held, without regard to the language of the insurance policy, that the insurance carrier cannot absolve itself of the duty to defend by paying amounts up to the policy limits. These courts have held that the duty to defend is independent of the duty to pay. Generally, these courts disregard a defense clause of a policy that attempts to extinguish the duty to defend upon policy indemnification. The courts reason that, in situations in which the insured causes multiple injuries, the insurance carrier will pay the coverage limits to terminate the entire defense obligation. Therefore, to prevent an early escape by the insurance carrier, these courts hold that the duty to defend is independent and continues after exhaustion of the policy amounts.

Other courts, however, hold that the duty to defend is dependent upon the duty to pay. These courts hold that the insurance carrier does not have a duty to defend after the insurance carrier pays the maximum amount required under the insurance contract. According to these courts, the primary obligation imposed on an insurer is to indemnify the insured. The other obligations of the insurance carrier are designed only to implement the primary obligation of indemnification. Hence, the obligation of defense exists solely to better enable an insurance carrier to indemnify the insured.

California courts have not followed either approach consistently. A California appeals court first explored the issue in 1976, in *Aetna Casualty & Surety Company v. Certain Underwriters*. In 1980, the

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118. See supra note 20 and accompanying text.
119. A. Windt, supra note 20, at 160-61 n.238 (cases cited therein).
120. Id.
121. E.g., American Cas. Co. v. Howard, 187 F.2d 322, 327 (4th Cir. 1951).
122. See id.
123. A. Windt, supra note 20, at 161 n.239 (cases cited therein).
124. Id. at 161.
125. Id.
126. Id.
127. 56 Cal. App. 3d at 798, 129 Cal. Rptr. at 51. The language in Communale v. Traders & General Ins. Co., 321 P.2d 768, vacated 50 Cal. 2d 654, 328 P.2d 198 (1958) cited by the
California Supreme Court examined the issue in *Signal Companies v. Harbor Insurance Company*. A close examination of both cases is necessary to understand the approach California courts take on the issue of whether the duty to defend is dependent upon the duty to indemnify.

### A. Aetna Casualty & Surety Company v. Certain Underwriters

In *Aetna Casualty & Surety Company v. Certain Underwriters*, appellants, Harbor Insurance Company (Harbor), Certain Underwriters at Lloyds of London (Lloyds), and the appellee, Aetna Insurance Company (Aetna), were insurers of Union Oil at the time of the Santa Barbara oil spill. Aetna, the primary insurer, defended Union Oil against claims resulting from the oil spill to the exhaustion of the $50,000 limit of the primary policy. Thus, although the damages assessed against Union Oil exceeded the coverage provided by Aetna, the entire defense cost was borne by Aetna, the primary insurer. Aetna brought an action for equitable subrogation and declaratory relief against the excess insurers, claiming that the duty of Aetna to defend terminated at the exhaustion of the policy obligation. Aetna sought a pro rata share of the defense costs from the excess insurance carriers.

The trial court in *Aetna* found that all the insurance companies had a responsibility to furnish a defense for Union Oil, but that the primary responsibility fell upon Aetna until the exhaustion of the policy limits. The trial court apportioned the costs of defense among the insurers, using the ratio of the amount paid by each insurance carrier...
to the total amount paid by all carriers in the settlement of claims and the satisfaction of judgments.\(^\text{135}\) Harbor and Lloyds appealed on the ground that, \textit{inter alia}, Aetna, as the primary insurer, had an obligation to defend Union Oil even after the limits of the insurance policy that Union Oil had with Aetna had been reached.\(^\text{136}\) This argument, however, did not prevail in the appeals court.\(^\text{137}\)

Appellants in \textit{Aetna} argued that the language in the Aetna-Union Oil liability contract was ambiguous and, therefore, the duty of Aetna to defend extended beyond exhaustion of the policy limits.\(^\text{138}\) Aetna had promised to defend with respect to "[s]uch insurance as is afforded by this policy."\(^\text{139}\) The appellants argued that "such insurance" was ambiguous and could refer either to the type and amount of the insurance or \textit{only} to the type of insurance.\(^\text{140}\) Under the standard rule of insurance policy construction, this ambiguity had to be interpreted in favor of the insured. Thus, appellants argued, Aetna had a continuing duty to defend claims arising from the one occurrence because the duty to defend would be limited only by the type of coverage and would continue regardless of the amount sought by the claimants.\(^\text{141}\)

The Second District Court of Appeal rejected this argument, employing numerous factors to evaluate the issue.\(^\text{142}\) The defense duties of both the primary and excess carriers were interpreted by the court in light of the several contracts of insurance, the relative position of the insured and the insurance carriers, and the nature of the calamity giving rise to the claims.\(^\text{143}\) The court stated that "(n)o single rubric nor any composite of selected rules of contract construction can alone decide the unique matter at bench."\(^\text{144}\) The court required that all carriers share in the costs of defending the insured.\(^\text{145}\) Since the entire defense burden would fall upon the primary carrier, the court reasoned

\(^{135}\) \textit{Id.} As of the date of the judgment, the percentage allocation was 3.77 percent for \textit{Aetna}, 35.85 percent for Harbor, and 60.38 percent for Lloyds. \textit{Id.}

\(^{136}\) \textit{Id.} at 797, 129 Cal. Rptr. at 51.

\(^{137}\) \textit{Id.} at 798-99, 129 Cal. Rptr. at 51-52.

\(^{138}\) \textit{Id.} at 799, 129 Cal. Rptr. at 51.

\(^{139}\) \textit{Id.} at 799, 129 Cal. Rptr. at 51.

\(^{140}\) \textit{Id.}

\(^{141}\) \textit{Id.} at 799, 129 Cal. Rptr. at 51-52.

\(^{142}\) \textit{Id.} at 800, 129 Cal. Rptr. at 52.

\(^{143}\) \textit{Id.}

\(^{144}\) \textit{Id.} The appellate court stated that if the duty to defend is separate from the duty to indemnify, then the argument can be made with equal force against the appellants that the duty of the excess carriers to defend does not depend upon the presence or absence of any duty by the primary carrier to defend against excess claims. \textit{Id.}

\(^{145}\) \textit{Id.} at 803, 129 Cal. Rptr. at 54.
that a contrary result simply would offer a windfall to the excess carrier who refused to defend.\textsuperscript{146}

The court in \textit{Aetna} limited the holding to the facts presented.\textsuperscript{147} The \textit{Aetna} holding required all insurance carriers to contribute toward the loss because the duty of defense by the primary insurer ended when the limits of the policy were exhausted. Although this holding indicates a belief that the duty to defend is dependent upon the duty to indemnify, the \textit{Aetna} decision left room for an entirely different holding. The duty to defend, stated the \textit{Aetna} court, may be deemed \textit{separate} from the duty to indemnify, and, under facts different from those involved in the \textit{Aetna} case, may be broader than the duty to indemnify.\textsuperscript{148} The court, however, failed to provide guidance on what circumstances would allow this expansion of the duty to defend. In deciding a case factually similar to \textit{Aetna}, the California Supreme Court relied upon \textit{Aetna} to hold a primary insurer liable for the entire defense burden.

\textbf{B. Signal Companies v. Harbor Insurance Company}

\textit{Signal Companies Inc. v. Harbor Insurance Company} was an action by a primary liability insurer against the excess insurer of an oil company.\textsuperscript{149} In \textit{Signal}, the Supreme Court of California affirmed a judgment relieving an excess carrier from any contribution for the costs of defense incurred by the primary carrier in defending a mutual insured.\textsuperscript{150} The court imposed the defense costs solely on the primary carrier rather than apportioning the cost between the primary and excess carriers as was done in \textit{Aetna}.\textsuperscript{151}

\textit{Signal} arose after the collapse of a dam near Los Angeles.\textsuperscript{152} The City of Los Angeles and the Los Angeles Department of Water and Power filed actions\textsuperscript{153} claiming $25 million in damages resulting from the dam failure.\textsuperscript{154} The complaints alleged that soil subsidence induced

\begin{itemize}
\item \textsuperscript{146} \textit{Id.}
\item \textsuperscript{147} \textit{Id.} at 804, 129 Cal. Rptr. at 55. \textit{Aetna} held that "under the facts at bench . . . the primary carrier Aetna had no further duty to provide a defense without the right of reimbursement from the excess carriers." \textit{Id.}
\item \textsuperscript{148} \textit{Id.} at 804, 129 Cal. Rptr. at 55.
\item \textsuperscript{149} \textit{Signal}, 27 Cal. 3d at 362, 612 P.2d at 891, 165 Cal. Rptr. at 801.
\item \textsuperscript{150} \textit{Id.}
\item \textsuperscript{151} \textit{Id.}
\item \textsuperscript{152} \textit{Id.} at 363, 612 P.2d at 891, 165 Cal. Rptr. at 801.
\item \textsuperscript{153} \textit{Id.} The City of Los Angeles and the Department of Water and Power filed actions both on their own behalf and as subrogors of the individual claimants. \textit{Id.}
\item \textsuperscript{154} \textit{Id.}
\end{itemize}
by subterranean oil well digging had weakened the dam structurally and induced the failure.\textsuperscript{155} The primary insurer provided for the entire defense of Signal Companies, one of numerous oil companies named as defendants.\textsuperscript{156} The litigation against all of the defendants was settled for approximately 3,000,000 of which $35,000 was contributed on behalf of Signal.\textsuperscript{157} The primary insurer indemnified to the policy limits of $25,000 and the excess insurer contributed $10,000.\textsuperscript{158} The settlement took place, however, after the primary insurer had incurred approximately $95,000 in legal expenses in defense of Signal.\textsuperscript{159} The primary insurer instituted the action to recover a portion of the $95,000 from the excess insurer.\textsuperscript{160}

The \textit{Signal} court acknowledged the disagreement among authorities regarding the issue of the duty to defend in relation to the duty to indemnify.\textsuperscript{161} The court, however, did not address the issue directly. According to the court, the issue was presented only peripherally since the exhaustion of primary coverage and the settlement of all claims occurred simultaneously.\textsuperscript{162} Under the terms of the excess insurance policy, the excess carrier was obligated to pay defense costs incurred prior to the commencement of trial only if the claim was settled for a sum in excess of the primary limits, and only if the excess carrier consented to a "continuation" of the action against Signal.\textsuperscript{163} Since the action was settled before trial, the court reasoned that no "continuation" of the action against Signal had taken place.\textsuperscript{164} The excess

\begin{footnotes}
\textsuperscript{155} \textit{Id.}
\textsuperscript{156} \textit{Id.}
\textsuperscript{157} \textit{Id.}
\textsuperscript{158} \textit{Id.}
\textsuperscript{159} \textit{Id.} at 364, 612 P.2d at 892, 165 Cal. Rptr. at 802.
\textsuperscript{160} \textit{Id.}
\textsuperscript{161} \textit{Id.} at 365, 612 P.2d at 892, 165 Cal. Rptr. at 802.
\textsuperscript{162} \textit{Id.}
\textsuperscript{163} \textit{Id.} at 364, 612 P.2d at 892, 165 Cal. Rptr. at 802. The undertaking of the excess carrier was in the contract as follows:

2. Apportionment of Costs. Costs incurred by or on behalf of the Assured [Signal] with the written consent of the Company [the excess carrier], and for which the Assured is not covered by the Primary. . . Insurers, shall be apportioned as follows: (a) Should any claim or claims become adjustable prior to the commencement of trial for not more than the Primary. . . Limit(s), then no Costs shall be payable by the Company. (b) Should, however, the amount for which the said claim or claims may be so adjustable exceeds the Primary. . . Limit(s), then the Company, if it consents to the proceedings continuing, shall contribute to the Costs incurred by or on behalf of the Assured in the ratio that its proportion of the ultimate net loss as finally adjusted bears to the whole amount of such ultimate net loss.

\textit{Id.} at 372, 612 P.2d at 897, 165 Cal. Rptr. at 807.
\textsuperscript{164} \textit{Id.} at 364, 612 P.2d at 892, 165 Cal. Rptr. at 802.
\end{footnotes}
carrier was absolved of defense cost liability under the terms of the excess carrier policy.\textsuperscript{165} Therefore, the excess carrier was not obligated to pay any portion of the $95,000 in defense costs incurred by the primary insurer.\textsuperscript{166}

The court was able to distinguish \textit{Aetna} because \textit{Aetna} involved the costs of defense when the primary insurance carrier clearly had exhausted the primary limits and the action had continued.\textsuperscript{167} In \textit{Signal}, however, the action was settled before the primary policy limits were exhausted. The primary carrier in \textit{Signal} argued that the principles in \textit{Aetna} should be applied to the facts before the court.\textsuperscript{168} These principles, if used, would require the excess carrier to participate in the defense of the insured as soon as the excess carrier is notified of a claim that might exceed primary insurance limits, even though the primary insurance coverage has not yet been exhausted.\textsuperscript{169} Relying upon \textit{Aetna}, the primary carrier in \textit{Signal} contended that the excess carrier had a coextensive duty to defend Signal because the potential liability of the insured was in excess of the combined coverage afforded by both insurance carriers.\textsuperscript{170} The court in \textit{Signal} rejected this application of \textit{Aetna} because the insurance policy of the excess carrier explicitly stated that liability of the excess carrier would not attach until the primary coverage has been exhausted.\textsuperscript{171}

In \textit{Aetna}, the court prorated the defense costs between the primary and excess carriers. Thus, the excess carrier was required to pay a share of the defense costs after the exhaustion of the policy limits of the primary carrier. In \textit{Signal}, however, the court rejected the proration of the defense costs and, instead, placed the entire burden of defense on the primary insurer. Thus, even though the claim was in excess of the primary policy, the primary carrier had to shoulder the entire defense burden. Both courts addressed the issue of whether an insurance carrier, after paying the full policy amounts, can terminate the obligation to defend the insured. With the holdings of \textit{Aetna} and \textit{Signal} in mind, this author offers a recommendation to clarify and solve this problem.

\textsuperscript{165} \textit{Id.}
\textsuperscript{166} \textit{Id.} at 365, 612 P.2d at 892, 165 Cal. Rptr. at 802.
\textsuperscript{167} \textit{Id.} at 366-67, 612 P.2d at 893-94, 165 Cal. Rptr. at 803-04.
\textsuperscript{168} \textit{Id.} at 366, 612 P.2d at 893, 165 Cal. Rptr. at 803.
\textsuperscript{169} \textit{Id.} at 367, 612 P.2d at 894, 165 Cal. Rptr. at 804.
\textsuperscript{170} \textit{Id.} at 366, 612 P.2d at 893, 165 Cal. Rptr. at 803.
\textsuperscript{171} \textit{Id.} at 367, 612 P.2d at 894, 165 Cal. Rptr. at 804.
RECOMMENDATION—A LINKAGE BETWEEN THE DUTY TO DEFEND
AND THE DUTY TO INDEMNIFY

The foregoing analysis of California case law shows that a clear rule regarding the duty to defend after exhaustion of insurance policy limits is difficult to state. The decisions are clouded with issues involving the relationship between primary and excess carriers and hence are of minimal value as precedent. As previously noted, the terms of an insurance contract, like most other contracts, can be varied by the parties. 172 Therefore, the proper "rule" will fluctuate according to the specific language of the insurance policy. Most insurance carriers, however, use similar language in their policies in an attempt to link the duty to defend to the specific indemnification provisions of the policy. 173 This author contends that in situations involving the use of this typical policy language, a linkage should exist between the duty to defend and the duty to indemnify. In other words, the duty of the insurance carrier to defend should terminate upon payment to the insured of policy limits.

Gray, Aetna, and Signal have suggested that the duty to defend is "broader" than the duty to indemnify. 174 The meaning of the term "broader", however, is not clear. The duty to defend is broader than the duty to indemnify in one sense because the defense of the insured from unjustified suits is one of the very purposes of liability insurance. 175 Thus, the insurance carrier must defend the insured against all actions brought against the insured that allege facts and circumstances covered by the policy even though such suits may be groundless, false, or fraudulent. 176 The insurance carrier may have to defend groundless suits, but, under the insurance policy, is required to compensate the insured only for actual losses. Hence, the duty to defend and the duty to indemnify are not always congruent because, although the facts may indicate absence of liability, Gray requires the insurance carrier to defend an action that potentially is within the coverage of the policy. 177

172. See supra notes 44-50 and accompanying text.
173. Id.
174. See Gray, 65 Cal. 2d at 275, 419 P.2d at 176, 54 Cal. Rptr. at 112; Aetna, 56 Cal. App. 3d at 804, 129 Cal. Rptr. at 55; see also Signal, 27 Cal. 3d at 367, 612 P.2d at 894, 165 Cal. Rptr. at 804.
175. Magarick, supra note 5, §1.06 at 14-15.
176. See supra notes 74-96 and accompanying text.
177. See Magarick, supra note 5, §1.06 at 15. Many courts have recognized that the term "broader" represents simply the requirement that the duty to defend is invoked upon the find-
If the word "broader" as used in Gray, Aetna, and Signal means that an insurance carrier has a duty to defend that continues after exhaustion of the policy limits, the courts would be declaring that the duty to defend is independent from the duty to pay. The rationale provided by those jurisdictions, which characterize the duty to defend as independent and severable, however, is uncertain. For example, one Arizona court declared that an insurance contract imposed two separate and distinct obligations upon the insurance carrier, namely, the duty to defend and the duty to indemnify. Thus, because the duties were independent, the court claimed the duty to defend extended beyond indemnification. Oddly though, the defense and indemnity obligations were considered severable because, according to the court, the insurance policy language presented a strong statement of the duty to defend.

The language of the defense clause, "as respects such insurance as is afforded by the other terms of this policy," however, would seem to indicate an intent of the parties to limit the duty to defend only to the indemnity limits of the policy. Nevertheless, the court treated the duty to defend independent from the duty to indemnify.

Jurisdictions finding that the duty to defend and the duty to indemnify are independent claim that if the duty to defend is dependent on the duty to indemnify, then the insurance carrier would be able to tender the policy amounts to escape a lengthy and costly defense of the insured. This argument is unfounded. Courts that currently hold the duties dependent do not allow the insurance carrier to escape the duty to defend by paying the full amount of the policy coverage to the court or to the insured. California courts simply would not have to allow an early escape. As a rationale for prohibiting the early

178. Magarick, supra note 5, §1.06 at 15.
179. See supra notes 118-22 and accompanying text.
180. Magarick, supra note 5, §1.05 at 12 (decisions that hold the duties independent "do not appear to be based upon logic and seem uncertain in their conclusions").
182. Id. at 309.
183. Id.
184. See supra notes 121-22 and accompanying text.
escape of an insurance carrier, the courts can apply the duty of good faith. As noted, when an insurance carrier defends an insured, the carrier is held to a strict rule of good faith upon assuming that responsibility. Thus, when a defense counsel, although paid by the insurance carrier, undertakes to represent the insured, the counsel owes the insured an undeviating and single allegiance. Early escape would be antithetical to this duty of good faith and should be prevented. Since the threat of insurance carriers to escape their full defense commitment is controllable by the courts, an explanation of the advantage of the linkage can be given.

If the duty to defend is held to be dependent upon indemnification, courts would be taking a more realistic view of the intent of the contracting parties. The intent of the parties should be the goal in contract interpretation, especially regarding the duty to defend. Thus, a critical factor in determining whether the duty to defend commences is the reasonable expectations of both the insured and the insurance carrier. In the indemnity context, the insured is intending to decrease the risk involved in a particular venture. Hence, the primary obligation imposed upon the insurance carrier should be to pay for the legal liability of the insured. Other obligations, like the duty to defend, are dependent upon this primary obligation and designed to implement that obligation.

The Aetna holding recognized the logic of the rule that the duty to defend is dependent upon the duty to indemnify. The Aetna court found that the primary insurer could be compensated by the excess carrier for the defense costs if the claim exceeded the indemnification limits of the primary policy. Thus, the court found that the duty to defend was dependent upon the duty to indemnify and terminated at the outer limits of indemnification. Having established that the intent of the parties would be fulfilled better when the duty to defend is dependent upon the duty to indemnify, this author next will examine the Signal decision.

Signal Was a Bad Sign

In Signal, the California Supreme Court required the primary insurer to pay the entire cost of defense even though the claim exceeded the

186. See supra notes 102-04 and accompanying text.
188. Magarick, supra note 5, §1.05 at 12.
189. See supra notes 71-73 and accompanying text.
190. Magarick, supra note 5, §1.05 at 12.
limits of the primary policy. The court stated that a settlement had occurred prior to any litigation for a claim that would have invoked the duty to defend. Thus, the duty of the excess insurer to defend never commenced. The excess carrier in Signal was required to indemnify for the portion of the loss over the limit of the primary policy, but the excess carrier was not required to help pay the defense costs. The defense costs borne by the primary insurer in Signal were $95,000, far in excess of the $25,000 indemnified by the primary insurer and the $10,000 indemnified by the excess insurer. Instead of holding the primary insurer liable for the entire defense cost, the court should have applied principles of equitable subrogation to allow the primary insurer compensation pro rata from the excess carrier. The doctrine of equitable subrogation is broad enough to include every circumstance in which one person, not acting as a volunteer or intruder, pays a debt for which another primarily is liable, and that in equity and good conscience should have been discharged by the latter. Thus, when the primary insurer settled in Signal for an amount greater than the primary coverage, the primary carrier was paying for a defense, which, in good conscience, partly should have been borne by the excess carrier. The subrogation of an insurance carrier should arise by operation of law whenever one carrier provides a defense to the insured that inures to the benefit of another carrier. This rule has been applied a number of times to co-insurers of the same risk. No equitable, legal, or logical roadblocks exist to preclude the application of equitable subrogation principles to the situation in Signal.

Courts applying the doctrine of equitable subrogation enable the insured to receive the quality of defense that the insured deserves.

191. See supra notes 149-71 and accompanying text.
192. See supra notes 162-66 and accompanying text.
193. See supra notes 165-66 and accompanying text.
194. See Signal, 27 Cal. 3d at 391, 612 P.2d at 908, 165 Cal. Rptr. at 818 (Staniforth, J., dissenting).
196. Signal, 27 Cal. 3d at 390, 612 P.2d at 908, 165 Cal. Rptr. at 818 (Staniforth, J., dissenting).
197. G. Couch, supra note 20, §61.4 at 77-78; Signal, 27 Cal. 3d at 387, 612 P.2d at 906, 165 Cal. Rptr. at 816 (Staniforth, J., dissenting).
199. Signal, 27 Cal. 3d at 391, 612 P.2d at 908, 165 Cal. Rptr. at 818 (Staniforth, J., dissenting).
200. Id. at 392, 612 P.2d at 909, 165 Cal. Rptr. at 819 (Staniforth, J., dissenting).
The duty to defend should encompass the same quality of defense in cases that are within the primary limits as exists in cases in which the claim exceeds the primary limits. Normally, an insured is guaranteed a quality defense because the interests of the insured and the insurance carrier are compatible, since both the insurance carrier and the insured want to minimize their liability. Under the rule in *Signal*, however, the interests of the insurance carrier become twisted. Since *Signal* held only the primary insurer liable for defense costs, the vigorousness of the defense was limited to the financial interests of the primary insurer, namely the first $25,000 of loss incurred. In *Signal*, the stake of the primary insurer was only $25,000, whereas the stake of both the primary and the excess carrier combined greatly exceeded that amount.

In short, the duty to defend must be coupled with equitable subrogation rights to achieve the reasonable expectations of the insured. The primary carrier, enjoying a contractual limit on liability, cannot be expected to provide as vigorous a defense as an excess carrier that stands to lose much more than the primary insurer. The reasonable expectation of the insured is that the insured will not be subjected to personal liability. This expectation is met when the insured receives a quality defense that prevents a judgment against the insured that would exceed the policy limits of the insured. Thus, by holding the duties independent and refusing to utilize the well established principle of equitable subrogation, *Signal* potentially left unfulfilled the expectations of the insured.

**CONCLUSION**

Under most liability insurance policies, the insurance carrier has a duty to defend the insured. This duty to defend usually arises from a clause in the liability policy. This author has explored two areas of contract construction that are unique to the insurance policy, namely, strict construction of the policy against the insurance carrier and the doctrine of reasonable expectations. Both of these protections indicate
a willingness of California courts to find a duty to defend even though a strict reading of the insurance policy might dictate otherwise.

The duty to defend usually is limited by the contract, but the duty may be expanded by the courts under special circumstances. In California, the insurance carrier is obligated to defend the insured against any action if the claim alleged *potentially* is within the coverage of the insurance policy. In a practical sense, this standard requires the insurance carrier to go beyond the specific allegations in the complaint, and, upon investigation, if the carrier discovers information that potentially would give rise to liability under the policy, then the insurance carrier is required to defend in the action. When an insurance carrier determines that the action potentially falls within the defense clause and accepts the defense of an action, the insurance carrier will be estopped from arguing that the claim is outside the policy coverage in a later trial. For this reason, if the insurance carrier is in doubt, the insurance carrier will use a reservation of rights agreement, thereby enabling the carrier to deny liability at a later date. The insurance carrier is obligated to exercise due care and act in good faith in the fulfillment of the duty to defend.

A split of authority exists among jurisdictions as to whether the duty to defend terminates upon the exhaustion of the duty of indemnification. One view holds that the duty to defend is dependent upon the duty to indemnify, while the other view treats the duties as independent. In California, the applicable rule is unclear. The Second District Court of Appeal, in *Aetna Casualty & Surety Company v. Certain Underwriters*, held that an excess insurer was required to contribute to the defense of the insured upon exhaustion of the policy limits of the primary insurer. *Aetna*, however, declared that the duty to defend may be separate from the duty to indemnify and under facts other than those involved in the *Aetna* case may extend beyond the duty to indemnify. In *Signal Companies v. Harbor Insurance Company*, the California Supreme Court held a primary insurer completely liable for the entire defense cost rather than apportion the cost between the primary and excess carriers as was compelled in *Aetna*. Thus, although not specifically addressing the issue, *Signal* implied that the duty of defense was independent from the duty to indemnify.

The better rule, as this author has urged, is that the duty to defend is dependent upon the duty to indemnify. Hence, upon exhaustion of the policy limits, absent a clause in the insurance policy to the contrary, the duty to defend should terminate. Applying this rule along
with principles of equitable subrogation to facts before the California Supreme Court decision in Signal, this author has shown that the primary insurer should have been compensated by the excess insurer for providing the entire defense. The application of equitable subrogation would fulfill the reasonable expectations of the insured.

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