Overview: The Importance of Insurance

The importance of insurance to our nation and world is obvious. Justice Black wrote in *United States v. South-Eastern Underwriters Association*, 322 U.S. 533, 540 (1943): “Perhaps no modern commercial enterprise directly affects so many persons in all walks of life as does the insurance business. Insurance touches the home, the family, and the occupation or the business of almost every person in the United States.” Indeed, it is almost impossible to imagine an event or transaction that does not involve insurance in some way.

Thus, when events or transactions give rise to disputes, the likelihood that insurance will be in the background – or perhaps the foreground – is very high. I introduced *Understanding Insurance Law* with the observation that “lawyers in virtually every kind of practice need at least a basic understanding of insurance law principles.” Beyond transactional work where insurance is highly relevant to managing risks when putting together deals or making a financial plan, “[a] lawyer prosecuting or defending a claim for personal injury or property damage is routinely concerned with whether the claimant will succeed in reaching insurance proceeds for a covered loss. A lawyer defending a company or individual in civil litigation is commonly engaged for that purpose by the defendant’s liability insurer.”

The observation that an understanding of insurance law is important for lawyers is equally apt for mediators. This presentation is designed, in the limited time made available, to outline some of the basic insurance law principles that frame both the substance and process of mediation.

I. What is Insurance?

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1 Prepared June 22, 2016.
A. **Insurance as a Tool to Deal with Risk**

Insurance is the primary mechanism through which individuals and organizations transfer risk and distribute loss. The inherent uncertainty of events can be described in terms of chance or probability. In insurance, this uncertainty is normally described in terms of *risk*. People make judgments about risk every day; some of this happens automatically with respect to life’s ordinary events, but sometimes the evaluation involves a complex question of risk management requiring detailed calculations and elaborate planning. For complex organizations, risk management is one of the most important activities in which the organization ever engages. Insurance should be understood as a supplement to other risk management tools, and one to which a person or organization turns as a last resort.

B. **Other Risk Management Tools**

People (and organizations) have a variety of tools to cope with risk; these include (a) taking steps to limit the probability of loss, as when one takes a step that makes it less likely that an accident will happen; (b) taking steps to limit the effects of loss, as when one invests in something that will reduce the consequences of a loss once it occurs; (c) diversification, which reduces the impact of a loss involving one asset through the possession of multiple assets; and (d) self-insurance, as when one creates a reserve out of one’s own assets to enable easier digestion of a loss should it happen. When someone has exhausted these other means of risk management and still has risk that the person or organization wishes to reduce or reallocate, the person will go to a market where organizations offer to assume the remaining risk in exchange for a payment by the person seeking to shed risk.

C. **Insurance as a “contract” through which “risk” is “transferred” and “distributed.”**

This, then, is the essence of the business of insurance: one person (the insured, who can be an organization) enters into a *contract* with another (the insurer, which is almost always an organization) pursuant to which the insurer agrees, in exchange for the insured’s payment of a consideration (this is the insurance premium), to assume the insured’s risk (a *transfer*) and then *distribute* it across a group of similarly situated persons, each of whose risk has been assumed in a similar transaction. It is risk aversion that leads insureds to markets to transfer risk that cannot be cost-effectively managed by other risk-management tools. This does not mean that insurers are risk-prefering; on the contrary, insurance companies are just as risk averse as any other economic actor. The difference is that insurance companies operate at a scale and size that enables them to take the risks they assume and distribute them across large pools where the law of large numbers enables the insurer to disperse the risk while simultaneously making highly accurate predictions of the number of losses that will occur within a large pool of insureds. This relative certainty that comes with large numbers enables the insurer to calculate premiums that need to be charged to cover the losses of the pool, the administrative costs of doing business, and (if a stock company) earn a reasonable profit.

D. **The World’s Dependence on Insurance**
Insurance is, at its core, the business of spreading risk so that uncertain future losses can become a predictable expense represented on the balance sheet as a premium for which an economic actor can budget. Indeed, it is this feature of insurance which makes commerce as we know it possible. To illustrate this point with a simple example, an entrepreneur who wishes to build a factory to start a new business will not do so if the entrepreneur must carry the 1-in-(say)-1000 risk (0.1%) of the factory’s destruction (a $1 million loss) by fire, hurricane, tornado, etc., an event that would lead to financial ruin. Although the event is unlikely to occur, most entrepreneurs would not risk a multi-generational disaster of this sort, which means that the investment will not occur. But if the entrepreneur can insure the factory with a renewable policy that charges a premium of 0.13% (i.e., enough to cover the expected loss, plus a small margin that reflects the insurer’s cost of doing business and a reasonable profit), the entrepreneur can put this predictable, recurring payment on the balance sheet and plan a future accordingly. Indeed, without insurance, it is impossible to imagine our domestic and global economies – indeed, our domestic and global societies -- existing in any form remotely similar to those which we experience today.

E. Insurance as Dispute Resolution

Creating security in the face of uncertainty is the core of the business of insurance. But when losses happen, as they inevitably will, the business of insurance becomes the business of claims processing and dispute resolution. This, of course, is where mediation enters the picture.

II. “First-party” versus “Third-party” Insurance

A. Categorizing Insurance

Insurance can be categorized in many different ways. It can be categorized by the nature of the risk insured, by the nature of the organization form of the insurer, or in accordance with how the insurance product is marketed. Categorization by risk is the most common; historically, this meant dividing insurance into the broad categories of marine, inland marine, life insurance, disability insurance, health insurance, fire and casualty insurance, and some other discrete kinds of insurance. In modern times, categorization by risk sorts insurance into the personal lines (life, accident, health, disability), property insurance (i.e., insurance on a policyholder’s interest in property), and liability insurance (i.e., insurance on a policyholder’s risk of being liable to a third-party, most commonly a victim of the policyholder’s tort).

B. First-Party and Third-Party Insurance

This modern categorization scheme is frequently refined further to the end of dividing the world of insurance into two categories, and it is this method of categorization that is most useful to someone viewing insurance from the perspective of a mediator. From the perspective of a mediator, the role that insurance plays in the mediation process depends on whether the underlying policy is one of “first-party” or “third-party” insurance.
1. **First-party Insurance Defined and Illustrated.** In first-party insurance, the contract between the insurer and the insured indemnifies the insured for a loss suffered directly by the insured. Property insurance, for example, is first-party insurance; the damage to the property is an immediate, direct diminution of the insured's assets. Stated more precisely, in property insurance, the loss is the damage suffered to the insured's interest in the property. Property insurance proceeds are paid to the insured directly in order to redress the insured's loss.

2. **Third-Party Insurance Defined and Illustrated.** Liability insurance, on the other hand, is understood as third-party insurance because the interests protected by the contract are ultimately those of third parties injured by the insured's conduct. Thus, liability insurance protects the insured against liability the insured may have to others. The insured suffers a loss when the insured is held liable to pay third parties for the consequences of the insured's conduct; but the insured’s loss is “indirect” in the sense that it is the third party that directly suffers the loss (as in the case, for example, of the insured negligently operating an automobile and causing injury to a third party as a result). The liability insurer will indemnify the insured against any liability the insured may have to the third party up to the limits of the insurance policy, and in this way protect the insured against any loss. In the event of payment, however, the insured at most serves as a conduit for transmission of the proceeds from the insurer to the injured third-party, and in most cases this conduit will be bypassed through a direct payment by the insured’s insurer to the third-party victim.

3. **All Insurance Except Liability Insurance is First-Party Insurance.** Property insurance was offered above as an example of first-party insurance, but in the modern categorization scheme, all insurance except liability insurance is fairly understood as first-party insurance. Life insurance may “feel” like third-party insurance in the sense that it is (usually) the insured’s designated beneficiary who receives the proceeds in the event of the insured’s death. But the way to understand life insurance is that it is the insured’s loss that happens when the insured dies; unless the insured chooses to create third-party beneficiary rights to the proceeds of the insurance contract, it is the insured’s estate (i.e., the successor to the insured) that receives the proceeds when the insured dies. It is possible for someone else to own the policy on the insured’s life, as when one party takes out insurance on the life of another (as is common when one spouse takes out insurance on the life of the other spouse), but the loss is still suffered by the person whose life is insured. Health insurance is somewhat uneasily categorized under this framework (indeed, whether health insurance is “insurance” at all is reasonably debatable for reasons outside the scope of this paper) because proceeds (i.e., payments) are typically made directly to health care providers under health insurance plan, but the insurance is designed, first and foremost, not to help health care providers (even if that comment obscures some delicate nuances in the product) but instead to help individuals who incur medical bills. Disability insurance pays the insured for the loss in income suffered by virtue of the insured’s illness or injury due to accident. Uninsured motorist (“UM”) insurance is best understood as first-party insurance, in that the insurer’s commitment under a policy sold to and purchased by the insured is to compensate the insured directly for injuries caused by a third-party in circumstances when the third-party has no liability insurance or other independent means to pay the insured for the
injuries suffered as a result of the third-party’s conduct. In UM insurance, it is as if the insurer’s first-party obligations are measured by reference to how the tort system calculates the liability owed by a third-party to the insured in circumstances where the third-party cannot pay the liability.

4. **Combination Products Where Both First-Party and Third-Party Coverage is Present.** This last point about UM insurance leads to an important insight about insurance products generally. In the early years of the insurance business, companies only sold one kind of product. In the mid-20th century, the industry evolved and “multi-line underwriting” became commonplace. Thus, a number of insurance products with which consumers are most familiar actually combine first-party with third-party coverage. For example, the homeowners’ policy is actually a policy of property insurance on the insured’s home (and its contents) combined with a general liability policy for the insured’s non-automobile-related liability exposures. A renters’ policy is built the same way, except that the property coverage is on the insured’s property, not the dwelling itself.

Likewise, automobile insurance is a package of multiple coverages, some of which, depending on the state in which the policy is sold, are required and some of which are optional. The liability coverage is the central pillar of the policy (as liability insurance is now required in every state), but combined with this coverage may be one or more of the following: (a) property insurance on the insured vehicle, which may cover damage to the vehicle in an accident (the “collision” coverage) which is not covered by a liability policy owned by a party whose fault causes the damage, or loss from non-collision events (e.g., a tree falls on the car, theft, etc.; this is the “comprehensive” coverage); (b) uninsured motorist protection, which, as described above, provides bodily injury coverage when the at-fault third-party is uninsured; (c) underinsured motorist protect, which provides bodily injury coverage when the at-fault third party’s liability limits are less than the liability limits carried by the insured for the benefit of third parties; and (d) medical payments coverage, under which medical and hospital payments will be made to the insured, or any injured occupant of the insured’s vehicle, or if the insured is injured in an automobile incident in some other capacity (e.g., as a pedestrian); sometimes this coverage extends to the expenses of a funeral, lost income from being unable to work, or losses incurred when an at-home spouse can no longer provide services in the home.

In business, sometimes a set of first-party and third-party coverages will be packaged together to give the organization the full range of needed protections, but it is more common, especially with small- and medium-sized businesses for the insured to purchase property coverage for business assets, commercial vehicle coverage for any vehicle-related liability exposures, and what is called the “Commercial General Liability” Policy, or “CGL,” for non-vehicular business-related liabilities. Although the CGL is the standard business form, in recent decades the number of exclusions in the CGL has increased, necessitating for many businesses the purchase of endorsements to the CGL or separate, free-standing policies. E-commerce and the liability exposures associated with the Internet and the Web, employment liability, and directors and officers’ insurance are examples of areas where liability policies supplemental to the CGL are frequently needed.
C. Conflict in First-Party Insurance

In the first-party insurance dispute, the conflict is between the insured on one side and the insurance company on the other. Presumably the conflict exists because the insurer believes no duty is owed the insured. This may be because of the insured’s conduct that allegedly makes the contract invalid (e.g., misrepresentation at the time of the application, fraud or false swearing in claims processing), the non-satisfaction of a condition to coverage (e.g., the insured’s late notice of a loss or failure to properly submit a proof of loss caused prejudice to the insurer, or the insured didn’t cooperate with the insurer in claims processing), the existence of a loss outside the coverage (e.g., the loss did not occur during the term of the coverage, or the loss was caused by an excluded peril), the insured’s failure to pay a premium when due, or some other defense offered by the insurer.

Regardless of how the issue is framed, the dispute involves two parties in a bilateral conflict; it is insured versus insurer, and the dynamic of the case, putting aside the obvious point that one side of the conflict involves an entity engaged in the business of insurance, is no different from any other dispute where two parties are at odds over the performance of obligations they owe each other. In liability insurance, the dynamics of the dispute are considerable more complicated, and it is this subject to which the next section turns.

III. The Special Dynamic of Disputes Involving Third-Party (Liability) Insurance

A. The Duty to Indemnify

In first-party insurance, the overarching duty of the insurer to the insured is to indemnify the insured for any loss the insured suffers to an insured interest due to a covered peril. This is the promise for which the insured bargains, and it is security against the consequences of such covered perils that the insured seeks.

In third-party insurance, the insurer’s duty to indemnify the insured is also a coverage that the insured seeks and highly values. Unlike property insurance where the insured’s interest will be limited by the value of the property, or the insured’s interest in the property, or unlike life insurance where the amount of coverage provided by the insurer is stipulated in the policy, an insured’s liability to third parties is potentially infinite, and thus the insured’s interest in being protected against liability to third parties is likewise potentially infinite (although, clearly, the insured’s assets to pay any resulting liability will not be infinite). If an insured is liable to a third party, that liability will have to be paid out of the insured’s own assets; liability insurance essentially protects – or indemnifies – the insured against suffering loss in the form of making payments to third parties to whom, either by judgment or settlement, the insured is determined to be liable.

B. The Insured’s Defense Cost Risk

Although insureds are keenly interested when claims are brought against them in being found not to be liable to third parties (even if liability insurance covers the eventual liability, a
valid claim on the policy is likely to lead to higher rates when the policy is renewed, just as an insured under a first-party property policy who submits claims for losses is likely to face a higher premium upon renewal), being indemnified is not the insured’s only concern. When someone is sued, that person must defend himself or herself in court (or else acquiesce in paying a judgment), and the costs of defense are rarely insubstantial. In fact, a party may be sued on a groundless or fraudulent claim – and this party will win the lawsuit, and thus there will be no obligation to pay a judgment, i.e., there is no liability and thus the insurer has no duty to indemnify. But the party will still endure the expenses of establishing that there was no liability, and it is this risk – the risk of having defense costs when a claim is brought by a third party – against which liability insurance also provides security.

C. The Duty to Defend as an Antidote for Defense Cost Risk

The insurer under a standard liability policy, in addition to assuming a duty to indemnify the insured in the event the insured is held liable to a third party, assumes a duty to defend the insured in a lawsuit brought by a third party alleging liability within a policy’s coverage. The source of this duty is contractual; the insurer undertakes to defend potentially covered claims by virtue of the language in the insurance policy itself. Thus, it is fair to describe liability insurance as “litigation insurance,” a kind of coverage that protests insureds against the financial costs associated with being sued.

Just as a liability insurer does not promise to indemnify the insured for any liability regardless of its nature (e.g., there is no promise to indemnify the insured for liability created by the insured’s intentional act to injure a third party, etc.), an insurer does not promise to defend an insured against all claims, whatever they might be. The insured, to establish entitlement to a defense, must carry the burden of establishing that the complaint’s allegations are potentially within coverage. Once this burden is carried, the duty to defend is owed unless the insurer can establish that the facts fall within an applicable exclusion.

D. The Tripartite Relationship: Insurer; Insured; Insured’s Attorney Appointed by the Insurer

Many complexities exist in determining whether a duty to defend is owed (for more discussion, see Jerry & Richmond, Understanding Insurance Law § 111, pp. 792-832 (5th ed. 2012)), but the salient feature of this insurance arrangement is a “tripartite relationship” – the (1) insurer retains and pays for (2) an attorney who provides representation to (3) an insured in connection with the third-party’s claims against the insured.

The tripartite relationship can be understood as a triangle where on each of the three sides one finds the following: (a) a contract between the insured and the insurer – this is the liability insurance policy itself which creates contractual obligations between insurer and insured; (b) a contract (or retainer agreement) between the insurer and an attorney under which the attorney agrees with the insurer to provide legal services for a third party (the insured) for which the insurer will pay on behalf of the insured; (c) a contract (or retainer agreement) between the
attorney and the insured under which the attorney agrees to provide legal services for the insured and obtains the insured’s consent for this representation.

E. Points of Tension in the Tripartite Relationship

Many points of tension exist inside the relationships represented in this insurer-insured-insured’s attorney triangle. When the insured appears in the mediation represented by counsel, a key point to recognize is that the attorney has ordinarily been selected by the insurance company. Once the attorney begins representing the insured, the attorney, regardless of the contract between insurer and insured, owes fiduciary duties to the insured, just as any attorney owes fiduciary duties and professional responsibilities to a client. If the insurer fails to defend the insured or does so inadequately, the insurer may be liable for breach of the contractual duty to defend. And if the attorney fails to protect the interests of the client(s), the attorney could be found to have violated the attorney’s professional obligations to the client and to have committed malpractice.

The nub of the problem is that the attorney has two masters: the insurer who retains her, pays the bills, and arguably expects the attorney not to do anything to impair the insurer’s interests; and the insured for whom the attorney appears, who probably has similar, albeit sometimes conflicting expectations, based on the insured’s payment of premiums. This is something of a tightrope for the attorney – although it is important to recognize that just because an attorney has multiple clients with sometimes divergent interests, it does not follow that the attorney has conflicting interests.

F. Adding Complexity: A “Fourth Point in the Triangle”

Above, the point was made that the tripartite relationship (insurer; insured; attorney) exists to defend against the claims of a plaintiff. In other words, there is fourth party whose behavior is crucial to the dynamic of the tripartite relationship, and that entity is the plaintiff (or third-party victim), represented by the third party’s attorney. As Tom Baker has discussed in a thoughtful paper in the *Connecticut Insurance Law Journal*, the dynamic of the insurance dispute in the third-party liability insurance situation should be understood as a tetrahedron, not a triangle.

A tetrahedron is an unfamiliar geometric shape to most people, perhaps because it has no presence (that I know of) in the Legos® world. In succinct terms, it is a four-sided object with a triangle on each side. Probably thanks to the Egyptians, the pyramid is more familiar to us; it is easily identified as a square base with four triangles, one of which sits on each edge of the base and all of which converge at a single point at the top. The tetrahedron has a triangle for the base (instead of a square) and the three triangles each of which sit on each edge of the base converge at a single point at the top.

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The image of the tetrahedron captures the idea that a dispute involving liability insurance involves four different tripartite relationships, where each of the players in the liability insurance dispute – plaintiff (represented by plaintiff’s counsel); insured; insurer; and insured’s attorney appointed by the insurer -- is actually interacting with the three other “players” in the dispute resolution dynamic. In other words, each player in the dispute is at one end-point on the tetrahedron, and from this end-point the player looks at and interacts with a tripartite relationship consisting of the other three of the four players. The four tripartite relationships, one of which is on each side of the tetrahedron, are: (1) insurer; insured; insured’s attorney appointed by the insurer; (2) plaintiff; insurer; insured; (3) plaintiff; insurer; insured’s attorney appointed by the insurer; (4) plaintiff; insured; insured’s attorney appointed by the insurer. Each of these tripartite relationships has features in its own dynamic that affect the work of the mediator. One of Baker’s insights is that whatever vantage point one has for viewing the tetrahedron, i.e., whichever triangles one is able to view, there is always one party (one point of the tetrahedron) that is hidden from view.4

G. Conflicts Between Insurer and Insured

The insurer-insured relationship is one side of two triangles in the tetrahedron. The most commonly discussed triangle is the “tripartite relationship” discussed above – insurer; insured; insured’s attorney appointed by the insurer. This is an extremely important triangle, because it collects all of the interests that will appear on one side of the table when the plaintiff litigates against or seeks to settle a dispute with the insured and the insurer’s allies. But the other triangle is highly relevant, because it reflects the reality that the plaintiff (through its attorney) has tools at its disposal to place pressure upon the insurer-insured relationship. The tetrahedron becomes the optic through which this dynamic can be observed. Initially, however, it is useful to outline how conflicts emerge in the insurer-insured relationship in liability insurance.

Actual or perceived conflicts between insurer and insured can arise in virtually countless ways, but on most occasions these conflicts fit within one of several categories:

(1) the insurer is defending the insured under a reservation of rights to contest coverage later, i.e., if a pro-plaintiff judgment results in the adjudication of the instant case; the insured is concerned that the insurer has a greater interest in showing facts that will defeat coverage than it does in successfully defending the insured;

(2) the plaintiff seeks punitive damages; if the insured’s policy does not cover punitive damages, and many do not, the insured is concerned that the insurer has no interest in defeating such a claim, whereas the insured has an obvious interest in doing so;

(3) the insured may wish to compensate the third-party victim injured by the insured’s allegedly negligent conduct, either out of some sense of a moral obligation or because the third-party is a friend or a relative, whereas the insurer has no such interest;

4 Id. at 103.
(4) the insurer may be interested in pursuing a litigation strategy that would establish favorable precedent for other cases in which it has an interest, but because the insured has no stake in these other cases, the insured may disagree with the insurer about how the case should be defended;

(5) the insured may have reputational or business interests that would be best served by settling the suit against it at any cost and regardless of liability, while the insurer is interested in vigorously defending or settling only on highly favorable terms;

(6) interests in the preceding example are flipped; for reputational reasons, the insured does not want to settle, but the insurer sees settlement as the most cost-effective way to resolve the dispute;

(7) the defense lawyer may in the course of information discover information that is highly favorable to one side and harmful to the other, and the defense lawyer cannot reveal the information without doing great damage to the interests of one side; and perhaps most common of all,

(8) the plaintiff’s claim exceeds the policy limits, and the insured strongly desires a settlement at or within policy limits in circumstances where the insurer believes a verdict far short of policy limits is achievable and should be pursued.

H. Impact of the Plaintiff’s Claim Being Within the Policy’s Limits

When the plaintiff’s claim is within the policy limits, all of these conflicts between insurer and insured do not necessarily disappear, but they are greatly reduced because the insurer’s money is what is at stake, not the insured’s. In such a circumstance, the insured is much less likely to be concerned about how the insurer defends and resolves the lawsuit. In fact, in some cases, getting the insured’s attention and cooperation when the insured has no exposure is the most difficult problem along the insurer-insured axis. This can lead to legal issues in and of itself because the one of the insured’s promises to the insurer in the liability insurance contract is to cooperate fully with the insurer in the defense of the claim. With respect to settlement, the insurer’s and insured’s interests will normally be aligned; the insured is satisfied as long as the settlement is within the policy limits, and the insurer will seek to settle the case as inexpensively as possible, but certainly within the policy limits because the plaintiff’s claim is within that limit.

I. Impact of the Plaintiff’s Claim Exceeding the Policy’s Limits

When the plaintiff’s claim exceeds the policy limits, the calculus changes, as now the insured has a financial stake in the outcome, and the interests of the insurer and insured may not be aligned. The insured does not want to litigate and be exposed to the risk of a judgment exceeding the policy limits, because the insured will be personal responsible for that excess. Thus, the insured greatly values any settlement at or below the policy limits. The insurer, on the other hand, has maximum exposure equal to the policy limits, and thus as a rationale economic actor is not influenced by the prospect of an excess judgment. If the insurer thinks the case for liability is weak, the insurer may prefer to litigate the case. For example, if the insurer and
insured both place the risk of a plaintiff’s judgment at 20%, the policy limits are $200,000, the plaintiff’s claim is $500,000, and the probability that plaintiff will be able to prove damages of $500,000 is 100%. The insured sees a 1 in 5 chance of being liable for $300,000 out of pocket if the case is not settled, whereas the insurer sees its maximum exposure as $200,000 and a 4 in 5 chance of winning the case and having no liability.

The “low limits” case in this hypothetical reveal a breakdown in the normal alignment of insurer’s and insured’s interests. On the plaintiff-insured-insured’s attorney side of the tetrahedron, the plaintiff’s attorney’s incentive is to draft settlement demands that influence the insured to retain separate counsel for the purpose of lobbying the insurer to settle within policy limits. On the plaintiff-insured’s attorney-insurer side of the tetrahedron, the potential for the insured’s attorney to want to please the insurer in order to garner more business in the future gives the plaintiff’s attorney an opening to “drive a wedge” between insured and insured’s attorney in the plaintiff-insured-insured’s attorney face of the tetrahedron.

The principles of insurance law are sensitive to this dynamic. Thus, the law regarding the insurer’s duty to settle (it is not a “duty” but is a “privilege” under the insurance contract, but the insurer generally controls settlement in most insurance cases) requires the insurer to treat the insured’s interests as if they were the insurer’s own, or respond to settlement offers as if there were no policy limits, or some similar formulation that ratchets up the insured’s interests in the formulation of responses to plaintiff’s settlement offers. What is important for the mediator to understand is that this dynamic is part of the background of the interests being projected on the defendant’s side of the equation – and that the plaintiff’s interests are in exploiting the potential conflicts on that side.

J. Impact of Uncertainty of Coverage for the Underlying Claim

In the potential conflict involving uncertainty of insurance coverage, the different faces of the tetrahedron help illustrate the special dynamic of the liability insurance dispute. Professor Baker offers this example: consider a situation where the insurer defends under reservation of rights because it believes there is a 50% probability that the insured’s misrepresentation on the application at the time of procuring the coverage will invalidate the coverage. Assume further that in the plaintiff’s action against the insured, there is a 50% chance of a $100,000 verdict and a 50% chance of a zero verdict. The settlement value of this case should be $50,000, but the rational insurer who perceives a 50% chance of prevailing in the coverage case should be willing to pay no more than $25,000 to settle the case (assuming zero defense and coverage litigation costs, which will not be the case, but which does not alter the point of the hypothetical). If the insured has collectible assets, the plaintiff should not settle the case for this amount. Again, the insurer’s and insured’s interests in settlement are not aligned, and the case is primed for impasse.

It is important for the mediator to be alert to this dynamic, but, once again, the principles of insurance law illuminate how this misalignment of interests might be adjusted. As it has developed, the law of bad faith in insurance law causes insurers not to seek contributions to settlements of claims within policy limits. But the underlying tension along the insurer-insured
axis in the tetrahedron is still present, and this adversarial dynamic will be present not just on the question of coverage but also with respect to how the claim is defended and settled.

K. Summary

Many more examples could be offered, but the essential point is the same: The complexities of the interactions of four parties -- (1), the plaintiff and the plaintiff’s attorney; (2), the insured; (3), the insurer; and (4), the insured’s attorney appointed by the insurer – in a case where liability insurance is present in the background are significant, and they are material to how a case will present itself to a mediator. Understanding how the different interests are arranged and presented in such a case is important to the mediator’s role.

IV. Definitions (and some other “Insurance Insights”)

Actual cash value: A limitation on the proceeds payable typically found in property insurance policies specifying that the insured may not recover more than the “actual cash value” of the property; often left undefined in the policies, most – although not all – courts have defined it as “replacement cost less depreciation”; to avoid the out of pocket losses associated with damaged to depreciated property, many insurers sell “replacement cost coverage” which eliminates the setoff for depreciation

Adjuster: a representative of the insurer who investigates insurance claims and recommends a settlement

Aggregate limit: In liability insurance, refers to the total policy limit for the total term for all occurrences or accidents that happen during the policy term; once the aggregate limit is exhausted, no indemnification is available for subsequent losses that happen during the remainder of the policy term

Allocation: In insurance, refers to the process through which a particular loss is assessed against multiple insurers, each of whom provide coverage for the loss or some portion of the loss

Binder: a contract that serves to effect insurance coverage for a specified period of time until the actual insurance policy can be issued. A binder can be issued either by a company or by a broker or agent with authority to do so

Broker: A licensed insurance agent who represents multiple carriers and is legally bound to serve the best interests of his or her clients

CGL: refers to “Commercial General Liability” insurance form, which is the successor to the “Comprehensive General Liability” policy that had been in use since the 1940s; provides general liability coverage for businesses
Coinsurance: refers to a kind of loss-sharing between insurer and insured, where the insured bears a portion of the loss that is a function of the percentage of the property’s total value not covered by insurance, or under which the insured agrees to bear a stated percentage of the loss.

Concurrent causation: refers to the possibility that multiple causes can combine to produce a loss where some of the causes are covered perils and others are either not covered or are specifically excluded.

Cumis counsel: with reference to a California case by that name, refers to the appointment of independent counsel to represent the insured (at the insurer’s expense) when a conflict of interest between insurer and insured becomes inescapable.

Declaratory judgment: Another approach for resolving a conflict of interest between insurer and insured; the insurer and insured are separately represented and the coverage or obligation-to-defend question is presented directly for resolution by the court.

Deductible: refers to a kind of loss-sharing between insurer and insured under which the insured bears the 100% of the loss up to the amount of the deductible.

“Defense within limits” policies: A type of liability insurance policy where expenditures on defense costs reduce the limits available for indemnification; sometimes called “burning limits” policies.

Direct action: refers to the exceptional situation in liability insurance where the victim of the insured’s negligent or other liability-producing behavior is allowed to sue the insured’s insurer directly, as opposed to suing the insured who then turns to the insurer for the defense of the action and eventual indemnification.

Disclaimer of coverage: A written notice to the insured stating that the insurer has determined that claims made against the insured are outside coverage and that the insurer will neither defend nor indemnify the insured for any judgment or settlement.

“Dual representation” model: Refers to a framework for the attorneys conduct of a defense of an insured under appointment by an insurer that allows the attorney to represent both the insurer and insured unless and until a conflict of interest that prohibits joint representation arises.

“Eight-corners” rule: A principle for determining when an insurer has a duty to defend; the “four corners” of the complaint are compared with the “four corners” of the insurance policy, and if the allegations of the complaint are within the coverage provisions of the policy, the insurer has a duty to defend.

Estoppel: In the context of liability insurance, generally refers to the rule followed by some courts that the insurer’s breach of the duty to defend will estop the insurer from denying coverage (meaning prevents the insurer from denying coverage).

Excess insurance: refers to the “layering” of insurance coverage, where the first layer of coverage is provided by the primary insurer, with other layers of coverage being provided by the
excess insurer; the layer of excess insurance will not be triggered until the primary layers are exhausted

**Excess judgment:** The portion of a judgment against the insured exceeding the limits of the policy

**Flood insurance:** government-subsidized insurance for the peril of flood, which insurance is unavailable in the private insurance market; the federal statute establishing the program is the National Flood Insurance Act of 1968, 42 U.S.C. §§ 4001

**Incontestability:** A statutory requirement in life and some other lines of personal insurance under which an insurer, in order to deny coverage or invalidate a policy based on fraud, misrepresentation, or concealment, must raise the defense within (normally) two years from the inception of the policy; after the designated period runs, these defenses become unavailable to the insurer, i.e., the policy becomes incontestable

**Insurable interest:** the requirement, which dates back to two statutes enacted by Parliament in England in the 18th century, and which is fundamental to being able to create an enforceable contract of insurance, that the person or entity purchasing insurance must have ownership of or some other legally recognized relationship to the property or life upon which the insurance is being purchased; the premise is that a person who has a relationship to the insured interest will be less likely to cause damage to (and more likely to take precautions to protect) the property or life in order to profit from the insurance

**Nonwaiver agreement:** A contract between insurer and insured in which the insurer agrees to continue with the defense, while the insured agrees that the insurer shall have the right to contest any issues relating to coverage in the event the insured is found liable in the underlying action; unlike a reservation of rights letter, a nonwaiver agreement is a contract between insurer and insured

**Notice of loss:** A requirement in property and liability insurance that conditions the insured’s coverage on the insured notifying the insurer of a loss within a reasonable time (e.g., “as soon as practicable”); in most jurisdictions, the insurer cannot deny coverage for late notice absent demonstration that the late notice prejudiced the insurer’s interests

**“Other insurance” clauses:** provisions found in property and liability insurance policies which purport to allocate the coverage among multiple policies that apply to the same loss; the common kinds of other insurance clauses are pro rata, excess, and escape clauses

**“Per Person/Per Occurrence” limits:** in liability insurance, refers to the amount of coverage available for each injured person and for each accident or occurrence; thus, a $100,000/$300,000 per person/per occurrence limits liability coverage to $100,000 for each person injured in an accident, and to no more than $300,000 for all persons injured in the accident, regardless of the number of persons injured

**Policy limits:** Refers to the fact that policies of property and liability insurance will have stated limits on the insurer’s responsibility to pay proceeds in the event of loss; these limits will appear
as absolute dollar limits; in property insurance, a separate limitation will often appear as “the amount to repair or replace” the property, which creates an alternative limit to the stated policy limits, with the insurer’s obligation being to pay whichever amount is lower

**Potentiality rule:** An alternative principle to the eight-corners rule for determining when an insurer has a duty to defend; the insurer must look beyond the language of the complaint and consider any facts brought to its attention or any facts which it could reasonably discover in determining whether it has a duty to defend; if there is a potential for coverage based on these facts, the insurer has a duty to defend

**“One-client” model:** Refers to a framework for the attorney’s conduct of a defense of an insured under appointment by an insurer that treats the attorney’s obligations as owed solely to one client, that being the insured

**“Reasonable offer” test:** Refers to a principle by describes the insurer’s obligation when responding to a settlement offer while defending a claim made against the insured; under this test, if the insurer acts in good faith and deals fairly when responding to a settlement offer, the insurer has complied with its duty to settle

**Reimbursement of defense costs:** In the context of liability insurance, generally refers to an insurer’s claim that if it defends a claim against the insured and in the underlying action the claim is found to be outside the coverage, the insurer will be entitled to reimbursement of defense costs expended in defending noncovered claims; courts are divided in whether to allow reimbursement of defense costs

**Reservation of rights letter:** In contrast to a nonwaiver agreement, a unilateral notice sent by the insurer to the insured stating that the insurer reserves the right to contest coverage despite its undertaking to investigate the claim and defend the insured

**Subrogation:** A principle of equity which, as applied to insurance, typically refers to the insurer, upon paying the insured’s loss, stepping into the insured’s shoes for the purpose of asserting and recovering upon claims the insured has against third parties related to the loss

**Valued policies:** In property insurance, refers to a type of policy where the insurer agrees to pay in the event of (usually) total loss the value of the property as stipulated in the policy, as opposed to determining the amount of loss under a post-loss adjustment process

**Wear and tear:** A reference to one aspect of the principle of “fortuity,” which requires that a loss must be accidental or unexpected in some sense to be insurable; under this principle, wear and tear is an ordinary, expected loss and is not insurable under a policy of property insurance