2018 CLM New York (Extra-Contractual) Conference
December 12, 2018
New York NY

Tick. . . Tick. . . Tick. . . KABOOM: Is Your Next Eroding Limits Policy Case the One That Explodes?

I. What are Eroding Limits Policies and Where Did They Come From?

Veterans and historians of the insurance market will recall that, in 1986, the Insurance Services Office (ISO) proposed that comprehensive general liability policies be offered on a "claims made" basis and, even more dramatically, that they include a "diminishing limits" clause by which claims expenses, including attorney fees incurred in defending a claim or lawsuit, would reduce the limits of the policy otherwise available for indemnifying the insured. Around that time, the author, in an article published by the American Bar Association's Tort and Insurance Practice Section (TIPS),[1] wrote:

> Because every defense dollar spent brings the insured closer to having his aggregate reduced, that inured would seem to have a clear financial interest in the costs of defense. Given [case law's] clear concern with the competing financial interests of insurer and insured, an argument can be made that, by applying defense costs so as to reduce an insured's available policy limits, insurance companies will completely forfeit the right to control the defense of that insured. . .This possibility is something which insurers should study carefully before blindly accepting the ISO defense cost provisions as a panacea for their legal expense dilemma. Adopting such provisions may cost them more in the short and long term than does any lawyer under the current system.

At that time, diminishing limits policies were not uncommon in professional liability policies. The attempt to expand their use into the CGL arena has not taken hold as may have been

[1] "Controlling the Defense: The Insurer's Hollow Crown" (1986). TIPS is now known as the Tort Trial and Insurance Practice Section

anticipated by ISO or others in 1986, but they are now quite often used to limit exposures of insurers professional liability and other niche markets.

Somewhat astonishingly, while case law has only increased its examination of what are now commonly recognized as competing interests of insurers and their insureds under the policies issued, the "diminishing limits" question has remained pretty well contained. Nevertheless, the issues raised and the potential or actual conflicts present between insurer and insured suggest that we are all one bad set of facts away from a groundbreaking and momentous court decision; for example, one that rules that diminishing limits policies are against public policy or create an inherent conflict of interest that cannot be waived. Such a result would have profound consequences for insurers and for the attorneys retained by insurers to represent insureds with diminishing limits policies.

II. Eroding Limits Provisions: Against Public Policy?

The "Hollow Crown" does not stand alone in raising the question whether policies with eroding or "burning" limits create an inherent conflict of interest between insurer and insured and between insurer-retained defense counsel and insured. For example, one commentator has suggested:

> There is an inherent conflict between the insured and the insurer in every case where payment of loss plus payment of defense costs could exceed the limits of liability, since every dollar spent on defense of the claim is a dollar that will not be available for settlement or satisfaction of judgment. This is no problem as long as the insured and insurer are fully agreed (and continue to agree) on the merits of settling versus defending including issues of timing and resources invested in the process.

Munro, Defense within Limits: The Conflicts of "Wasting" or "Cannibalizing" Insurance Policies, 62 Mont.L.Rev. 131, 148 (2001).

As should be expected, the courts have begun to weigh in on the possibility as well, some even going so far as to consider whether eroding limits policies might be against public

policy altogether. For example, the Supreme Court of Appeals of West Virginia clearly considered the question, although ultimately limiting its holding to policies issued pursuant to a statute specifically governing liability policies issued to municipalities. In *Gibson v. Northfield Ins. Co.,* 219 W.Va. 40, 631 S.E.2d 598 (2005), the estate of someone killed by a city-owned vehicle brought a lawsuit against the insurer of the City after taking an assignment of the City's rights to coverage. The estate claimed that the insurance policy in question was void as against public policy to the extent that it held defense costs to be part of the limits of the policy. The court considered the provision in light of a governing statute and held that it was indeed contrary to the legislative intent. However, in so doing, the court limited its ruling to policies of insurance issued to municipalities, stating:

> *[O]n a more general note, we believe that the inclusion of a defense within limits provision in a governmental entity's insurance policy offends traditional notions of fairness. Governmental entities purchase liability insurance to protect their employees and to protect [public funds]. The quiet inclusion of a defense within limits provision into a governmental entity's liability policy subverts that intent by using the liability coverage to pay the insurance company's litigation expenses and attorney fees, rather than protecting the governmental entity and its employees and making injured third parties whole against their losses.*

Despite the limitations of this particular decision, however, the court's analysis leading to its holding does not seem unique to municipal insureds and could easily expanded to insureds under professional liability policies and to insureds generally.

In *Illinois Union Insurance Co. v. North County Ob-Gyn Medical Group*, S.D. California, 2010 U.S. Dist. Lexis 50095, at *6 (S.D. Cal. May 18, 2010), the court held that policy language attempting to reduce coverage limits by defense expenses could not be enforced because the insured could not have known that its policy limits would be eroded by defense costs.

There are, however, many policy provisions reducing coverage limits that have been upheld by various courts.[2] Clearly, while courts struggle with the proper analysis under the particular set of facts presented in the case then before them, predictability will be very difficult to gauge and the premonition that the next controversy may be the one that blows the roof off this somewhat still-contained issue looms large. Perhaps the best lesson lies in the decision of the federal district court in *NIC Ins. Co. v. PFP Consulting, LLC,* CIV.A. 09-0877, 2010 WL 4181767 (E.D. Pa. Oct. 22, 2010), which held that the determination of whether an eroding limits clause in an insurance policy is against public policy is a matter better addressed and resolved by the Pennsylvania state courts and not the federal courts. Attorneys and insurers alike (as well as authors of legal articles and periodicals) should be cautious about making general and overly broad pronouncements about the enforceability of burning limits in policies of insurance. There may indeed be no national answer to this question. The potential state interests considered by courts across the country underscore just how crucial it may be to engage in a state-specific analysis of this important issue.

III. Eroding Limits Provisions and Reservation of Rights

It should be obvious to all that insurers need to be especially careful when communicating with their Insureds about the terms of diminishing limits policies. When coverage limits are eroding as litigation is defended, the timing of the reservation of rights can become as crucial as the content. Thus, in *Lexington Ins. Co. v. Swanson,* 2007 WL 1585099 (W.D.Wash. 2007), one of the parties sought to invalidate the insurer's coverage defenses based, in part, on the claim that the insurer's control of the defense under a diminishing limits policy created a conflict of interest. The argument presented, as in other cases and legal commentary, was that a conflict

[2] *See, e.g.*, *Continental Ins. Co. v. Bangerter*, 37 Cal. App. 4th 69 (Cal. App. 1995); *California Dairies, Inc. v. RSUI Indemnity Co*., 2010 U.S. Dist. Lexis 64049 (E.D. Cal., June 25, 2010) (Loss means damages, settlements, judgments, and defense expenses); *Weber v. Indemnity Insurance Co. of North America,* 345 F. Supp. 2d 1139 (D. Haw. 2004) (Defense expenses include the attorney's fees, legal costs, and expenses spent to defend the underlying suit).

arose because, while the insured would likely wish to settle the claim in order to avoid the potential excess and personal exposure, the insurer's interest could be in defending the lawsuit in order to avoid liability entirely, without having to face any exposure beyond its policy limits, thereby paying the same amount whether or not the settlement offer was accepted but saving money if settlement were rejected and the case successfully (although expensively) defended.

The district court agreed based on the fact that the insurer had controlled the defense of the litigation for nearly two years before issuing a reservation of rights. In the eyes of the court, this raised a presumption that the insured was prejudiced. The insurer was therefore precluded from asserting contract defenses to coverage. However, the court noted that this ruling applied to coverage defenses, not to the limits themselves.

> *Consequently, although the insurer was now barred from litigating its defenses to coverage, it could still rely on the policy's spend-down provision to dispute the applicable policy limit without a timely reservation of rights.*

While the *Swanson* court was willing to enforce the policy's maximum limits as written, insurers face a double-barreled threat in any litigation contesting burning limits clauses: (1) the argument that the clause violates public policy, is ambiguous or otherwise unenforceable; and (2) the claim that the insurer, because of its conduct in the face of conflicts of interest created by the eroding limits nature of its policy, is or should be estopped from contesting coverage in any manner. In the face of these threats, the third possibility, rejected by *Swanson* but easily imagined, is that, because of the conflict of interest and the conduct of the insurer, the insurer will remain liable for defense fees and expenses in addition to indemnity limits. This is especially foreseeable where an insured claims that it should be entitled to extra-contractual damages due to a failure to settle and/or an excess verdict.

IV. Implications of Eroding Limits Provisions: Settlement Demands and Responses

Everyone understands that the courts and public policy writ large favor the amicable (or occasionally court-induced) settlement of lawsuits. Courts are clearly more likely to grant motions to approve settlement agreements in cases involving burning limits policies. Indeed, the cases in which a settlement is threatened or an insured is confronted with personal (uninsured) exposure due to a refusal of an insurer to settle, likely present the greatest incentive for a court to issue a broad ruling against the enforceability of eroding limits clauses generally. These cases would also severely restrict the control a diminishing limits insurer may exercise in defending litigation. Moreover, it is just these kinds of claims that make for tempting targets for extra-contractual claims and extra-contractual rulings.

Thus, in a decision upholding the Depositors Economic Protection Corporation Act against an equal protection challenge, the Rhode Island Supreme Court noted the likely impact that the “defense within limits” policies would have in the absence of settlement given that the alternative is allowing the policies to deplete by payment of attorney’s fees and litigation expenses leaving no limits left to satisfy a judgment. *Rhode Island Depositors Economic Protection Corp. v. Brown,* 659 A.2d 95 (1995). This was similarly noted in a decision approving the settlement of a class action alleging fraud, where the court expressly considered the fact that the applicable insurance policy was “self-consuming” and, therefore, that defense costs and expenses would continue to reduce the amount of coverage available to satisfy any judgment. *Scholes v. Stone, McGuire & Benjamin,* 839 F. Supp. 1314 (N.D. Ill. 1993).

These issues are legitimately seen as real and not merely vague and horrible hypotheticals. Courts recognize that, when an insurer believes that a claim is of little merit, it may wish to defend the claim through trial and that, in doing so, the insured’s coverage limits will be completely or significantly eroded. The courts further recognize that, in contrast, the

insured is much more likely to want its insurer to make a substantial and early offer to the plaintiff in order to obtain a dismissal and thereby be protected from even a small chance of an uninsured excess verdict liability. In *Biomass One, L.P. v. Imperial Casualty & Indemnity* Co., 968 F.2d 1220 (9th Cir. 1992), the insurer paid $1.9 million in legal fees and costs defending a professional liability claim under a $2 million policy where the court found the policy language ambiguous. Although the result of this case was a ruling that the legal fees did not erode the available indemnity limits, reversing the district court's grant of summary judgment to the insurer, the opinion would not appear to be a significant threat to well-written eroding limits policies. As the court noted in *Biomass One*, the policy in question did not contain any single and unambiguous statement that the limits of coverage were subject to defense fees and expenses. Thus, insurers should again note the admonition that attempts to create an eroding limits policy must be the result of careful and effective draftsmanship, as well as consistent claims practice.

V. Issues for Defense Counsel

All defense lawyers representing insureds, whether retained by the insured or the insurer, must remember that they represent and owe a duty of utmost loyalty to that insured. Accordingly, there are a number of challenges that defense counsel face even in the day-to-day defense of a claim under a diminishing limits policy, regardless of whether viewed as an inherent conflict of interest.

For example, while defense counsel cannot become embroiled in any coverage contest with the insurer when they have been retained by an insurer, they must nevertheless be aware of and sensitive to the existence and implications of an eroding limits policy on the defense of the insured. A burning limits policy puts the onus on defense counsel to make certain that they communicate early and often with the insured and to ensure that the impact of defense fees

and expenses on defense choices and strategies are well understood. This becomes even more complex in situations – common in professional liability policies, for example – wherein the insured has the right to consent to any settlement. Such early and effective communication should undoubtedly include sharing an early case budget and evaluation with the insured, especially when one has been or will be prepared for the insurer.

Discovery and disclosure issues are likewise fraught with potential peril for defense counsel. For example, when preparing answers to interrogatories and initial case disclosures regarding applicable insurance, must defense counsel state expressly that the available policy limits are eroded or reduced by defense costs and attorney fees? Is the mere indication of the amount of the limits, without such a caveat, sufficient? What are the strategic advantages and disadvantages of complete disclosure? Would choosing not to disclose the eroding limits provision of coverage be justified by those strategic considerations on behalf of the insured or do court and jurisdictional rules simply mandate full disclosure? These and other similar questions are challenging and need to be closely examined by defense counsel on a jurisdiction-by-jurisdiction basis.

Furthermore, defense counsel should be aware that governing rules of professional responsibility might force them to continue representing an insured after the exhaustion of liability insurance limits. In most states, when an attorney seeks to terminate the representation of a client in litigation, that attorney may only do so after taking reasonable steps to avoid foreseeable prejudice to the client. Further, an attorney, after having appeared for a client in court, may only withdraw from such representation in compliance with the applicable rules of such court. These ethical obligations apply regardless of who was paying for defense counsel's services prior to such termination. As such, when the insurance company retaining the defense counsel claims that its policy limits have been exhausted under an eroding limits provision and

stops paying for the insured's defense, the defense counsel may find themselves unwittingly providing pro bono services, unable to withdraw due to the likely prejudice to the insured were withdrawal granted.

Also crucial to the communication insurer-retained defense counsel undertakes with the insured is the nature of what could be an inherent conflict of interest. While research has uncovered no case directly on point, it nevertheless does not appear to be a giant stretch to imagine that a court would likely find a conflict of interest between the attorneys' interest in being paid for its vigorous representation of the insured (as is required under rules of professional responsibility) on the one hand and the insured's desire to have maximum insurance protection for an adverse judgement or a settlement. Given this reality, defense counsel that does not disclose this potential would seem to be operating at a risk just as significant as the exposure to extra-contractual damages and estoppel faced by insurance companies who similarly ignore the opportunity to disclose these circumstances to the insured.

VI. Issues for the Insurer

Insurers issuing eroding limits policies should be on their guard to make certain that their insureds are fully advised about the existence of that provision and its ramifications. Recognizing it expressly as creating a potential conflict of interest may ultimately be the best course although in some states such as Illinois, that would likely trigger an obligation to advise of that insured's right to independent counsel at the expense of the insurer (reasonable fees and expenses). While this loss of control of the defense may offer a somewhat bitter pill to swallow, the consequences of a court ruling that the conflict exists inherently and the fact that it remained undisclosed estops insurers from relying either on policy defenses of the coverage limit and further exposes them to extra-contractual and bad faith damages is, in reality, much worse.

Likewise, insurers should most likely communicate with the insured regarding the potential for a verdict that could exceed the policy limits. Because every defense dollar diminishes the insured's protection, the insurer issuing eroding limits policies should make certain that systemic processes and procedures are in place both to control litigation costs and the costs incurred by attorneys representing their insureds. Such policies further emphasize the need to keep the insured current as to aggregate defense costs and the amount of remaining coverage.

As noted above, settlement opportunities present special challenges under diminishing limits policies. The insurer should be able to demonstrate that, at all times, it considered the impact of eroding limits when responding to settlement demands and considering case values. Insurers should encourage defense counsel to explore settlement early and throughout the litigation. As is incumbent on defense counsel, so, too, the insurer should, as soon as possible, develop an evaluation, recommendation and budget regarding case value and settlement possibilities for all claims. Should that budget or case developments reveal that policy limits will be significantly eroded by defense costs, the insured should be made aware promptly and kept involved in all material case developments and decisions thereafter. The insurer's files should make it clear beyond any doubt that the insurer was always aware of and sensitive to the fact that the protections afforded to the insured were very much impacted on a daily basis by the defense of the case and that, at all times, the insurer strove to protect the insured's interests, even at the short-term expense of its own.

VII. Conclusion

Eroding limits policies may be advantageous to a particular part of the insurance market, may fill a need of insureds for affordable coverage and may provide insurers with an effective and certain mechanism for litigation cost control and reduction of expense. They may

also, however, be more trouble than their worth, especially if insurers (or even one of them) act badly or without sensitivity to their insureds and do so under the wrong facts, in the wrong state or with the wrong attorney and corporate witness representing them. Outcomes in future court cases are difficult to predict and the development of this area of the law is uncertain.

One thing is easy to predict, however. Ultimately, should the wrong case present itself, all diminishing limits policies are likely to be deemed unenforceable or so severely restricted in their offering as to be impracticable and useless in the insurance market. Insurers and defense counsel must each take extra steps and devote additional effort to make certain that their practices meet their duties of good faith and loyalty to the insured. Failure to do so will undoubtedly have significant consequences and the insureds are rarely left carrying the ultimate financial burden in these kinds of disputes. When the ticking time-bomb of eroding limits policies finally explodes, make certain that yours is not the company that triggered it and that you are not the defense counsel caught in the blast.

Mitchell A. Orpett
Tribler Orpett & Meyer, P.C.
312-201-6413
maorpett@tribler.com