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DEFENSE WITHIN LIMITS: THE CONFLICTS OF "WASTING" OR CANNIBALIZING" LIABILITY POLICIES

BY PROFESSOR GREG MUNRO

While most liability policies contain a duty to indemnify, which is subject to a limit of liability clause, they also feature a duty to defend which is virtually unlimited. Insurers have developed a policy in which the "limit of liability" available to indemnify the insured against verdicts or settlements is reduced by the costs of defense. Such a policy is called a "defense within limits" (DWL) policy, also known as "wasting,"¹ "cannibalizing," "self-consuming,"² or "self liquidating"³ because its available indemnity limit may be eaten or "wasted" by the costs of defense. The industry adopted DWL policy provisions for medical malpractice policies in the 1970s in response to patient claims that were increasing in number

and size. Insurers incorporated DWL provisions for directors' and officers' policies for corporate boards during the 1980s in response to heavy defense costs involved in the savings and loan cases and toxic tort litigation. In the 1980s, insurers placed DWL into legal malpractice insurance. At that time, lawyers were concerned that the industry was forcing them to change from "occurrence" to "claims-made" policies, and the fact that the insurers had inserted DWL provisions into those same policies went virtually unnoticed. I have surveyed lawyers at CLEs in Montana and learned that even today, most do not know they have DWL policies, and do not appreciate the importance of those provisions.

Reasons for development of the DWL policy provisions

Insurers developed DWL policies because costs of defense in the high-risk cases involved in professional liability insurance and directors' and officers' insurance commonly equal costs of indemnity and often exceed limits of liability. While this has prompted insurers to limit their duty to defend, it is hard to see how DWL policies benefit insurance consumers. When the professional liability insurers inserted the DWL provisions, they abandoned their nominally unlimited duty to defend and promised only defense insofar as its costs fit in the limit of money available for indemnity. Insurers contend that they had to adopt DWL because expenses in defending claims were rivaling losses paid. This has probably always been true, and the real problem here is that claim complexity, policy limits, and costs of defense are proportional. By the 1980s, the policy limits bought for predicted high-risk liability protection had simply grown to a size where the insurers were unwilling to make an equal commitment for risk of defense expenditures.

The emergence of DWL provisions meant that consumers of Directors' & Officers', Errors & Omissions, and some Commercial General coverages now have to calculate their potential loss exposure as well as the potential costs of defense in buying their insurance. Whether they gain any tangible benefit is questionable. Industry asserts that the insured can obtain significant savings by purchasing DWL policies.⁴ However, such assertions must be tested against the fact that the risk-averse insured must now double limits to cover the amount deducted for costs of defense. At least one actuary asserts that there is no need for DWL provisions in liability policies because actuarial rate making

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procedures allow pricing of such policies at a profitable level without deducting defense costs from the limit.⁵

DWL policy provisions

The DWL policy form from the Insurance Services Office, Inc., the trade organization for the industry, generally features three modifications from the standard ISO form casualty policy. First, the basic insuring agreement traditionally provides that the company's obligation to pay or defend terminates when the limit of the company's liability has been exhausted by payment of judgment or settlement. For DWL, that provision is modified so that the limit can be exhausted not only by payment of judgments or settlements but also by "claims expenses." Second, the limit of liability clause is altered so that the "aggregate" limit of the company's liability includes not only damages but also "claims expenses." The limit of liability clause may also provide that "claims expenses" are subtracted from the limit of liability before indemnity and that the company has the right to withdraw when the limits are exhausted. The limit of liability clause may then provide for a "deductible" and "reimbursement" in the event the insurer has indemnified or paid defense expenses that exceed the limit of liability. Third, the policy will carry an additional definition for "claims expenses" so that the term will cover all legal defense costs.

In the area of legal malpractice in 1999, the ABA reports that 42 of the 47 insurers providing coverage include defense costs within their limits of liability.⁶ About 12 of the companies allow exceptions by endorsement⁷ which likely involves increased premiums. Some include defense costs in limits after an annual, i.e., \$50,000, defense allowance or a \$25,000 per lawyer annual defense allowance. Some make supplemental defense coverage available either as a percentage of the per claim limit, i.e., 25%, or a set amount, i.e., \$500,000 or a combination, i.e., the lesser of \$100,000 or 50% of the per claim limit.⁸

Misrepresentations in marketing the DWL policy

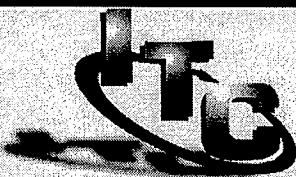
Because of the marked change in coverage between a policy that provides an unrestricted duty to defend and a policy providing DWL, counsel should watch for intentional or negligent misrepresentation if the insurance intermediaries doing the marketing are not careful in representing limits of liability. Sales materials or policy language indicating that a policy has "indemnity" limits of a certain amount, when in fact the limit is subject to deduction for expenses of defense would raise risk of misrepresentation. Even stating limits of liability may involve the same risk absent some language of notice in the policy that defense expenses are deducted from the available limit.

Oregon requires that the DWL policy form give notice that defense costs are deducted from the limits available for liability.⁹ Montana has no such provision. A policy containing

representations about liability limits and also containing DWL provisions might be found to be ambiguous by reason of conflicting provisions, or because the policy layout and design misleads or allows the insured to have a reasonable expectation that it contains a limit of liability unfettered by defense expenses.¹⁰

Rights and duties of the parties under the DWL policy

Under the DWL policy, there is an inherent conflict between the insured and the insurer in every case where payment of the potential loss plus payment of predicted 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. The problem is that the insured has a direct interest in assuring that the limit of liability is available for settlement or payment of judgment, while the insurer may be interested in



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defending on the merits. It may be in the financial interest of a risk-averse insured to offer the entire limits even in a case of poor liability rather than run risk that hard fought defense will deplete the limits and block settlement later or leave an unsatisfied judgment. It may be in the insurer's interest, on the other hand, to establish through hard fought defense that "nuisance" claims will not invoke any settlement offers from this insurance company.

Because the insured under a DWL policy must evaluate both risk of loss and risk of defense costs, it may now be necessary that defense counsel provide the insured full information on the costs of defense. Furthermore, the insured, in attempting to control the costs, may seek to exercise more direction and control over the defense. The lower the limits of insurance available in relation to the potential loss and costs of defense, the more risk the insurer will take if it does not accede to the insured's demands for direction and control. This is an area in which the insurer may be exposed to risk of claims for bad faith

or excess exposure. Indeed, one actuary author believes that the conflicts raised and the rights of the insured in the face of the conflicts increase the chances that the insurer will have no limit on its liability for losses or for expenses of defense and the chance that the insurance defense counsel will be liable to the insured for malpractice.¹¹

Reservation of rights

There is no conflict if the insurer elects to defend unconditionally, since estoppel will later prevent the insurer from withdrawing defense.¹² However, if the insurer defends under reservation of rights, there is potential conflict, since the carrier may only be concerned about the interim costs of defending while the insured must worry about the ultimate cost and payment of loss. Where the insurance policy contains DWL provisions, the insurer may find itself giving notice of reservation of right that it will ultimately withdraw when defense expenditures exceed the limits of liability. If the insurer defends under reservation

of right to withdraw when the policy limit is exceeded, it is defending under a conflict insofar as it may provide a token defense, or provide a "win at any cost" defense while failing to work for the lowest possible settlement.

Control of the defense

Where counsel is defending under a DWL policy and where cost of defense coupled with the potential loss payment likely will exceed policy limits, a conflict may arise with regard to the conduct of the insured's defense. A vigorous defense by counsel may quickly deplete the policy limit and allow the insurer to withdraw leaving the indemnity limit exhausted and the insured exposed. When defense costs are subtracted from the indemnity limit, defense counsel has substantial power to affect the insured's ability to respond to settlement offers or verdicts. Consequently, under conflict logic, the insurer should cede the right to select counsel to the insured unless the limit is so substantial that there is no potential to exhaust it. The risk to the carrier "who acts wrongfully in

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satisfying its duty to defend" is the potential for being estopped from denying coverage beyond the limit.¹³

Under a DWL policy, the insured, proceeding in its own defense, has a direct interest in keeping the attorney fees at a minimum and in controlling the defense. If the insurer refuses to defend, the insured will contend that it is a bad faith breach. If the insurer defends, the insured may fault the decision to defend instead of settling and will likely demand settlement for any figure within policy limits. Many insurers offering directors' and officers' coverage avoid this problem by selling policies that are not only DWL but contain no duty to defend. These are indemnity only policies under which the insurer reimburses defense expenditures only after the insured selects counsel, controls the defense, and submits the defense bill.

Duty to settle

Once the DWL insurer has determined that there is coverage or has undertaken defense outright or under reservation of rights, it is bound also by a duty to settle if settlement is in the insured's interests. Standard language in the basic insuring agreement in liability policies reserves to the insurer the discretion to settle a claim. Because the insurers have reserved to themselves the right to settle, the courts have found that they also have certain duties to settle.¹⁴ The United States District Court for Montana in *Jessen v. O'Daniel*¹⁵ in 1962 found one of the duties to be "negotiating for a settlement where a fair and honest appraisal of the case requires such action." In the landmark case of *Communale v. Traders & General Ins. Co.* in California in 1958¹⁶, the court said protection by way of settlement was one of the benefits that inured to the insured under a policy and that, as a matter of good faith and fair dealing, the insured owed a duty to settle in appropriate cases. The

court there said that "in determining whether to settle, the insurer must give the interests of the insured at least as much consideration as it gives to its own interests; and that when there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consid-

In determining whether to settle, the insurer must give the interests of the insured at least as much consideration as it gives to its own interests.

eration in good faith of the insured's interest requires the insurer to settle the claim."¹⁷ in *Crisci v. The Security Insurance Company of New Haven, Connecticut*,¹⁸ the court said that the test to determine whether an insurer has given consideration to the interests of the insured is "whether a prudent insurer without policy limits would have accepted the settlement offer."¹⁹ There is nothing that exempts the insurers with DWL provisions from these settlement obligations.

Demand for settlement within the policy limits

Insurers take demands for policy limits seriously, since their rejection is considered tantamount to declaring the policy limitless.²⁰ The insurer's dilemma in DWL policies is knowing what exactly constitutes a policy limit demand. It could be 1) an offer to settle for the policy limit or less than the policy limit, 2) an offer to settle for the balance of the policy limit after subtracting defense costs to date, or 3) an offer to settle for the reasonable amount that will be left after deduction of reasonably predicted defense costs. Given the pressure that can be exerted on settlement negotiations by placing the insurer in a situation of potential bad faith, it will only be a matter of time before such issues are litigated.

The conflict for the plaintiff's attorney

If available insurance contains DWL provisions, aggressive tactics by plaintiff's counsel may not be in the best interest of the claimant because every dollar plaintiff's counsel forces the defense to spend is a dollar not available for settlement or payment of the verdict. Plaintiff's counsel will have much more incentive to make early attempts to negotiate settlement and to negotiate agreement on limiting discovery, pretrial motions, and other matters that can waste the asset represented by the indemnity limit. This may prove to be an incentive for cooperation since the defense attorney also must be attentive to limiting costs of defense for the protection of the insured.

If settlement attempts by plaintiff's counsel meet with rejection or an aggressive stance by the defense, plaintiff faces the prospect of fighting a battle that will reduce the money below that necessary for settlement or satisfaction of verdict. In such a situation, plaintiff has every incentive to attempt to manipulate the insurer into a position of having made a bad faith decision by refusing to settle and engaging in expensive defense. Plaintiff may have an ally in the insured who hopefully will have independent counsel to monitor the decisions of the insurer.

Withdrawal of defense on exhaustion of limits

Normally, if an insurer has undertaken defense of a claim without a reservation of rights, withdrawal is out of the question.²¹ In *Transamerica Ins. Group v. Chubb and Son, Inc.*,²² the court held that the insurer was estopped to deny coverage where it had defended for ten months, citing the facts that the insurer chose counsel, conducted the defense, did the initial investigation, and controlled negotiations.²³ The basic insuring agreement in a DWL policy will generally

contain a provision allowing the insurer to withdraw when the limit has been exhausted by claims expenses or loss payment. However, even under a DWL policy, withdrawal may sometimes be thwarted. Courts generally estop insurers from withdrawing even when they have policy rights to do so 1) if the case is too near trial, 2) if the insurer has done something to prejudice the insured, or 3) if the insurer has defended for a long period of time.²⁴ If the policy contains clear DWL provisions and a clear right of the insurer to withdraw upon exhaustion of the limits by expenses, categories (1) and (3) should not present problems of prejudice since counsel can continue defending and the only change will be in who pays. However, if the insurer and the insured have disagreed on defense versus settlement, the insured will, under (2), contend that the insurer has in the course of defending prejudiced the case by exhausting the pool of money left for settlement or verdict. While the insured could seek a remedy for such a wrong after it had defended itself by bringing an action for breach of contract for failure to settle, there is a risk that a court would simply disallow the withdrawal.

Furthermore, if the insurer is held to have wrongfully withdrawn, the majority rule is that the insured does not have to defend itself and may settle the case without consent.²⁵ At that point, the insured only has a duty to cooperate but not minimize the insurer's exposure.²⁶

Does the policy really provide defense within limits?

While professional liability policies and directors and officers liability policies have long contained express DWL provisions, the courts have recently hosted disputes about whether certain Commercial General Liability "CGL" policies provide defense within limits. Faced with enormous potential liability from the savings and loan collapse and toxic torts cases and the concomitant magnitude of the costs of defense involved in such cases, some carriers attempted to read DWL provisions into standard CGL policies. In *Bankers Trust Co. v. Imperial Casualty and Indemnity Company*,²⁷ Imperial, which had spent \$2 million defending and only had limits of \$2 million, took the position that those defense costs counted toward the \$2 million limit of liability and sought a court declaration that its coverage was exhausted. In fact, Imperial's policy appeared to be a standard CGL policy with a standard basic insuring agreement and "limits of liability" provision. In holding that Imperial's policy was not DWL, the 7th Circuit said:

"Imperial believes that its policy is among the minority that counts defense expenditures toward the limit of liability. It did not tell LKA or its other insured so in 1985, when it issued the policy; indeed, Imperial's interpretation of

its policy appears to be a recent discovery."²⁸

Noting that federal courts had, in unpublished decisions, ruled twice previously that Imperial's CGL policies were not DWL,²⁹ Judge Easterbrook wrote, "we publish this decision and trust that Imperial will desist."³⁰ The Bankers Trust and unpublished decisions against Imperial Casualty and Indemnity make clear the twin propositions that DWL cannot be read into the standard CGL policy and that the insurer, being the drafter of the policy, is not in a position to argue that a policy provides DWL by virtue of ambiguity.

Insurers have unsuccessfully attempted to convince courts that their promise to indemnify against judgments that contain attorney fees or costs means that the policy is a DWL policy. See, for example, *Planet Ins. Co. v. Mead Reinsurance Corp.*³¹

And in *Grunewald & Adams v. Lloyds of London*,³² the insurer tried to persuade the court that the fact that the insured's deductible applied to costs and expenses made the policy a DWL policy.³³ The appellate court ruled that costs of defense were included only in the deductible and not in the definition of aggregate liability.³⁴

Ambiguity may prevent the court from enforcing a DWL provision. In *Branning v. CNA*,³⁵ the court found that the juxtaposition of three different clauses on three different pages along with the use of the separate terms "loss" and "claims" would allow

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a reasonable interpretation that the policy would provide both defense costs and the \$3 million limit of liability coverage.

On the other hand, a court will enforce an insurance policy that expressly provides for DWL. In *Helfand v. National Union Fire Insurance Company*,³⁶ the Court of Appeal found the policy was not ambiguous and was "self-consuming" in nature.³⁷ The court noted that the policy definition of "loss" included defense costs and that defense costs were payable against the limits of liability just like any other element of "loss." The policy contained a caption to an endorsement that said "COSTS, CHARGES AND EXPENSES AND DEFENSE INCLUDED IN LIMITS OF LIABILITY, and that the endorsement stated that when payment not exceeding the "Limit of Liability has to be made to dispose of a claim, costs, charges, expenses and settlements shall be payable up to the Limit of Liability."³⁸

Sometimes the issue is whether the primary insurer can count defense costs in exhausting its limits and triggering coverage of the excess insurer. In *Coleman Company, Inc. v. California Union Ins. Co.*,³⁹ the primary carrier sought a declaration that its policy was DWL to escape having to pay costs of defense when the ultimate verdict would likely have to be paid by the excess carrier. Such issues are not unusual between excess and primary carriers, who attempt to shift defense costs to each other.

Statutory Law on Defense Within Limits

Some states have enacted statutes regulating or prohibiting DWL provisions in insurance policies. However, what little regulation of DWL provisions exists in state statutes consists of prohibiting DWL outright only on certain types of insurance, i.e., auto insurance or low limit policies, and allowing the commissioner discretion in the high risk coverages, i.e., professional liability, environmental, and large commercial risk.

Only one state, Oregon, requires that the policy contain any particular notice provisions.⁴⁰ Montana prohibits any provision in a casualty insurance form "permitting defense costs within limits, except as permitted by the commissioner in his discretion."⁴¹ The statute gives no guidance to aid the commissioner's exercise of discretion, and DWL provisions are common in Montana for E&O and D&O policies.

Conclusion

If DWL was adopted to contain the unpredictability of defense costs in the face of increasing complexity of litigation, one cannot help but think that it was unnecessary. Simple adoption of a "limits of defense" provision similar to a limit of liability with disclosure on the declarations page would have promoted certainty.

The problem with adoption of the DWL provisions is that they engender conflicts that did not exist in the standard form policies. DWL provisions produce conflicts between the insured and insurer that heighten the risk of bad faith or excess coverage claims against the insurer. They also increase the number of situations in which courts may rule that the insurer has a policy that is limitless for defense and for indemnity. It may be a fact, however, that the financial benefit of DWL provisions to the insurers will outweigh the detriment of any potential bad faith or excess claims suits. Counsel must understand the potential conflict inherent in DWL policy provisions.

NOTES

1. *Helfand v. National Union Fire Insurance Company of Pittsburgh, PA*, 10 Cal. App. 4th 869, 877; 13 Cal. Rptr. 2d 295, 197 (1992).
2. *Helfand*, above, at 13 Cal. Rptr. 2d 298.
3. Jeffrey A. Tidus, "Self-Liquidating Policy Limits: Benefits and Risks to Lawyers," Spring 1996 American Bar Association National Legal Malpractice Conference.
4. Michael Bradford & Linda Collins, ISO's Defense Cost Plan Meets Mounting Criticism, BUS. INS. 1, 29 (July 8, 1985).

5. Martin Rosenberg, Inclusion of Defense Costs in Policy Limits: An Analysis of the Potential for Failure of a Policy Form, 8 Journal of Insurance Regulation 446, 447 June 1990.

6. Selecting Legal Malpractice Insurance, American Bar Association, Standing Committee on Lawyer's Professional Liability, 1999 Ed.

7. *Id.*

8. *Id.*

9. Or. Rev. Stat. §742.063 (1992).

10. See, *Branning v. CNA*, 729 F. Supp. 728(1989).

11. Rosenberg, *supra*, note 5, at 450.

12. Allan D. Windt, INSURANCE CLAIMS AND DISPUTES §4.20 (3 ed. 1995).

13. *Id.*, at §4.22, pg. 230 *citing* Shelby Steel Fabricators, Inc. v. United States Fidelity & Guaranty Ins. Co., 569 So. 2d 309, 312-13 (Ala. 1990) for the "implication" that the insurer will be automatically estopped from denying coverage.

14. Keeton & Widiss, INSURANCE LAW, Sec. 7.8(a), (HBSE 1988).

15. 210 F. Supp 317, 319 (1962).

16. 50 Cal. 2d 654, 658-659, 328

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P.2d 198, 68 A.L.R. 2d 883.

17. *Id.*, 50 Cal. 2d at 659, 328 P.2d, at 201.

18. 66 Cal.2d 425, 58 Cal. Rptr. 13, 426 P.2d 173 (1967).

19. *Id.*

20. While case law sets out "prudent insurer" tests in such decisions as *Crisci*, above, the strict liability suggestion of cases such as *Communale*, 50 Cal. 2d at 659, 328 P.2d at 201, leads insurance defense counsel commonly to advise their client insurers to consider themselves strictly liable for excess coverage, if a verdict comes back in excess of the limit within which they have rejected an offer.

21. 14 Couch, Insurance 2d §51.85 (2d ed. 1982) quoted in *Safeco v. Ellinghouse*, 223 Mont. 239, 725 P.2d 217 (1986).

22. 16 Wash. App. 247, 554 P.2d 1080 (1976).

23. *See*, also, *Beckwith Machinery Co. v. Travelers*, 638 F. Supp. 1179 (W.D. Pa. 1986), (thirteen month defense) and *Safeco v. Ellinghouse*, above (eighteen month defense).

24. *Windt*, *supra*, note 12, at §4.30, pg. 248.

25. *Windt*, *supra*, note 12 at §4.18.

26. *Id.*

27. 7 F.3d 93 (CA7 1993).

28. *Id.*, at 94.

29. *Biomass One, L.P. v. Imperial Casualty and Indemnity Co.*, 968 F.2d 1220 (9th Cir.); *International Insurance Co. v. Imperial Casualty & Indemnity Co.*, No. CV 91 5494 JGD, 1992 WL 547721 (C.D. Cal. Oct. 28, 1992, appeal pending, No. 92-56551 (9th Cir.)).

30. *Id.*

31. 789 F.2d 668 (9th Cir. 1986).

32. 145 Ariz. 190, 700 P.2d 888 (Ariz. App. 1985).

33. *Id.* at 889.

34. *Id.*

35. *Supra* note 10.

36. *Supra* note 1.

37. *Id.*, at 10 Cal. App.4th 880.

38. *Id.*

39. 960 F.2d 1529 (1992).

40. Or. Rev. Stat. §742.063(2)(1992).

41. MCA §33-1-502.

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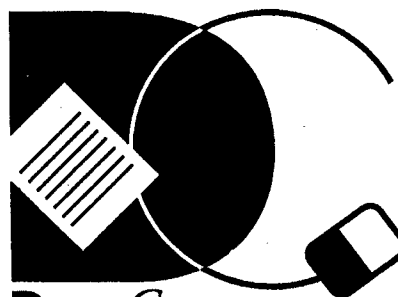
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