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

Gregory S. Munro*

"What all this means is that one way or another, the consumer is going to pay for the losses and expenses incurred by insurance institutions in standing by and behind professional conduct."1

I. INTRODUCTION

This article deals with casualty insurance policies that include expenses of defense in the limit of liability which is normally available to indemnify against losses. The article will discuss the reasons for development of such policy provisions and the conflicts engendered by them for insureds, claimants' lawyers and defense counsel. The author asserts that the real problem with Defense Within Limits ("DWL") policies is not that they attempt to contain defense expenditures, but that conflicts result when the policy gives the insurer the potential ability to completely deplete the available indemnity limit coupled with the insurer's right to exercise sole discretion in settling, defending and selecting counsel. The article will analyze alternative legal solutions to the problems created by DWL policies and will make recommendations for resolving the issues raised by the policies.

II. DEFINITION OF DEFENSE WITHIN LIMITS

The bulk of casualty insurance policies are not defense within limits policies. Auto insurance policies, as well as homeowners and commercial general liability policies, provide for defense expenditures in addition to the limits of liability.

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However, in such areas of casualty coverage as professional liability and directors' and officers' liability, the policies tend to contain provisions that clearly place them in the "defense within limits" category. Sometimes, as will be seen later in this article, whether the policy is a "defense within limits" policy is at issue. For purposes of this article, it is necessary to clarify what this author means by the "standard" liability policy as opposed to that defined as "defense within limits."

A. The "Standard" or Non-DWL Policy

Under most liability insurance policies, the insurance carrier has the twin duties of providing defense of the claim and indemnifying the insured against liability.\(^2\) The basic insuring agreement of the standard liability policy will contain some variation of the insurer's promise to indemnify, that is, to pay damages arising out of the insured's liability.\(^3\) The agreement will then provide for defense of any "suit" against the insured for damages covered by the insurance.\(^4\) The language setting out the duty to defend is generally followed by the qualification that "the Company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the Company's liability has been exhausted by payment of judgments or settlements."\(^5\)

Such casualty policies invariably contain a limit of liability clause that limits the amount of money the carrier will pay out under the promise to indemnify.\(^6\) However, there is no such

\(^2\) However, Directors' and Officers' "liability" insurance is actually indemnity insurance under which there is no duty to defend. The insured must defend, pay for defense and then seek reimbursement from the insurer. David S. Borden et al., Directors and Officers Liability Insurance Deskbook, 1998 A.B.A. Sec. Tort and Insurance Practice Section, 293.

\(^3\) "We will pay those sums that the insured becomes legally obligated to pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies."

\(^4\) See, e.g. id. "We will have the right and duty to defend any 'suit' seeking those damages. We may at our discretion investigate any 'occurrence' and settle any claim or 'suit' that may result."

\(^5\) MILLER'S, supra note 3, at 453.8.

\(^6\) Id. Provision 31 at 415 provides as follows:

1. The Limits of Insurance shown in the Declarations and the rules below fix the most we will pay regardless of the number of:
   a. Insureds:
   b. Claims made or "suits" brought; or
DEFENSE WITHIN LIMITS

limit on the amount of money the carrier promises to expend on defense of the insured under the conventional policy. The costs of defense are not included in the limit of liability, which only applies to the insurer's obligation to indemnify, so the carrier's promise to defend is essentially unlimited. For purposes of this article, this author will refer only to policies in which the limit of liability applies only to losses and not defense expenses as "standard" policies.

B. The Defense Within Limits (DWL) Policy

A policy in which the limit of liability available for paying losses is reduced by the costs of defense is called a "defense within limits" (DWL) policy. Such a policy is also known as a "wasting," "cannibalizing," "self-consuming" or "self liquidating" policy because its available indemnity limit may be eaten or "wasted" by the costs of defense. Such DWL policies have been used for Directors' and Officers' ("D & O") liability for some time. Some of the D & O policies actually contain no duty to defend and leave defense costs entirely to the insured.

III. THE DWL POLICY PROVISIONS

It is helpful here to set out the provisions that generally distinguish a DWL policy from a policy with no limit on the duty to defend. While some policies require a tortured interpretation

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c. Persons or organizations making claims or bringing "suits"

2. The General Aggregate Limit is the most we will pay for the sum of:
   a. Medical expenses under Coverage C;
   b. Damages under coverage A, except damages because of "bodily injury" and "property damage" included in the "products-completed operations hazard"; and
   c. Damages under Coverage B.

8. Id. at 879.
10. The author will refer to inclusion of defense costs within the limits of liability as "defense within limits" or "DWL" because that phrase is most descriptive of the provision. Whether the provision wastes, cannibalizes or liquidates the indemnity limits may depend on whether defense costs or indemnity is given priority in exhausting the limits of liability.
to glean their implicit DWL provisions, others have been recognized as explicit DWL contracts. Insurance Services Organization, Inc. (hereinafter "I.S.O."), the trade organization for the casualty insurance industry, drafts policy forms for the industry. The I.S.O. has drafted explicit DWL provisions which merit consideration here.

The I.S.O. DWL policy form generally features three modifications from the standard I.S.O. form casualty policy. First, the standard 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. Under the standard (non-DWL) form, the insurer faced with a claim that exceeds limits cannot simply tender the limits and withdraw from the defense. The insurer must defend until the case is settled on its merits or a verdict is rendered so the limit can be expended on the resulting judgment. Under the DWL policy, that provision is modified—the liability limit may 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

13. See, e.g., Bankers Trust Co. v. Imperial Cas. and Indem. Co., 7 F.3d 93, 94 (7th Cir. 1993) (where Judge Easterbrook said, “Imperial’s interpretation of its policy appears to be a recent discovery”).


15. Note that the property/casualty insurance industry trade association, the I.S.O., drafts form policies for most types of casualty insurance. These forms and loss experience data arising from their use are available to I.S.O. member insurance carriers which will often adopt the forms either verbatim or with minor modifications. Hence, the policies are somewhat uniform in their provisions. One should further note that such a service is possible only because the industry is exempt from federal antitrust legislation under the McCarran-Ferguson Act, 15 U.S.C. §§ 1011-15 (2001).

16. See, e.g., MILLER'S, supra note 3, Lawyers Professional Liability Insurance Form GL 00 23 03 81 (1981), provision 1C3, at 453.8 which provides:

The company shall not be obligated to pay any claim or judgment or to defend or continue to defend any suit after the applicable limit of the company’s liability has been exhausted by payment of judgment, settlements or CLAIMS EXPENSES.

17. See, e.g., id., provision 4A2, at 453.8 stating:

Subject to the above provisions with respect to “aggregate”, the total liability of the company for all damages and CLAIMS EXPENSES arising out of the same or related professional service shall not exceed the limit of liability stated in the [declarations] as applicable to “all claims arising out of the same or related professional services”.
from the limit of liability before indemnity, and 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 the term will cover all legal defense costs.

As one might imagine, there may be some variation in the
way insurers approach DWL. For example, in the area of legal
malpractice, the American Bar Association ("ABA") reports that
38 of the 48 insurers providing legal malpractice coverage
include defense costs within the limits of liability in their
policies. Approximately 13 of the companies with DWL
provisions allow exceptions by endorsement, which likely
involves increased premium. Some companies include defense
costs in limits after a certain defense allowance.

18. See, e.g., id., provision 4A3, at 453.8, stating:
All CLAIM EXPENSES shall first be subtracted from the limits of liability, with
the remainder, if any, being the amount available to pay as damages. If the
limits of liability hereunder are exhausted prior to settlement or judgment of
any pending claim or SUIT, the company shall have the right to withdraw from
the further investigation or defense thereof by tendering control of such
investigation or defense to the INSURED.

19. See, e.g., id., provision 4A4, at 453.8, which provides:
Deductible. The company's obligation to pay damages and CLAIMS EXPENSES
resulting from claims arising out of the same or related professional services
applies only to the amount of damages and CLAIMS EXPENSES in excess of any
deductible amount, if any, stated in the [declarations].

See also id., provision 4A5, at 453.8.

Reimbursement of the Company. If the company has paid any amounts in
settlement or satisfaction of claims or judgments or for CLAIMS EXPENSES in
excess of the applicable limit of liability, or within the amount of the applicable
deductible, the INSUREDS, jointly and severally, shall be liable to the company
for any and all such amounts and, upon demand, shall pay such amounts to the
company.

20. See, e.g., id., provision 6A, at 453.9, which provides:
"CLAIMS EXPENSES" means (1) fees charged by an attorney or arbitrator
designated by the company, and (2) all other fees, costs and expenses resulting
from the investigation, adjustment, defense of a claim, arbitration or SUIT,
arising in connection therewith if incurred by the company, but "CLAIMS
EXPENSES" does not include Supplementary Payments, salary charges of
regular employees or officials of the company or fees and expenses of
independent adjusters.

See also id., provision 6B, at 453.9, providing:
"SUIT" includes an arbitration proceeding to which the INSURED is required to
submit or to which the INSURED has submitted with the company's consent.

21. See chart included in Selecting Legal Malpractice Insurance, American Bar
Association, Standing Committee on Lawyers' Professional Liability, 2001 Ed.

22. Id.
For example, Lawyers Mutual Insurance Company of California provides DWL after a $50,000 annual defense allowance on policies with maximum liability limits of $5 million per claim and $7 million aggregate. The Oklahoma Attorneys Mutual Insurance Company policy is DWL after a claims expense allowance of the lesser of $100,000 or 50% of the per claim limit on maximum limits of $10 million each claim. Florida Lawyers Mutual Insurance Company makes supplemental defense coverage available in the amount of 25% of the per claim limit with a $1,000,000 maximum on liability limits of $20 million each claim.23

Overall, it appears that approximately 22 of the 48 companies offering legal malpractice insurance allow some form of option for defense costs outside the limits of liability, presumably for a higher premium. St. Paul Fire & Marine offers three options: DWL, DWL with supplemental defense expense coverage equal to the limit of liability, and defense outside limits with no limit of liability ("standard" coverage). Looking at the three companies mentioned above that have a defense cost allowance in their DWL policy, one can see that $50,000 and $100,000 defense cost allowances on multi-million dollar liability limits really mean that the entire cost of any substantial defense will be subtracted from the liability limit. The insured will need the sophistication to recognize this change and increase limits accordingly. Regardless of options which result in higher premiums, it is clear that the DWL policy is the rule and not the exception in legal malpractice policies.

IV. THE DEVELOPMENT OF DWL POLICY PROVISIONS

DWL policy provisions appear in policies covering liabilities that might be considered high risk. Thus, they appear in medical malpractice policies, legal malpractice policies, directors and officer's liability policies and in some manuscript commercial general liability policies. The complexity of cases in those areas, as well as the amount of dollars at issue, makes the cases hard fought and the defense costs substantial. Because this article’s premise is that DWL provisions raise many legal issues and conflicts about the defense of these high risk cases under the policies, it will be instructive to first consider the history of the provisions and the reasons the insurers developed

23. *Id.*
them in the different liability policies.

A. History of DWL Policy Provisions

1. Medical and Legal Malpractice Policies

The DWL policy is not entirely new. In the 1970s the insurance industry wanted more predictability in the face of medical malpractice claims which were increasing in number and size. Hence, the industry included "allocated loss adjustment expenses" in the liability limits of medical malpractice insurance policies.\(^{24}\) Ironically, DWL was not adopted in legal malpractice coverage until the 1980s because no similar increase in legal malpractice claims occurred in the 1970s,\(^{25}\) and the low loss activity in legal claims resulted in low premiums.\(^{26}\) When legal malpractice claims increased in the 1980s, the industry also introduced DWL into legal malpractice insurance. At that time, the focus of concern among lawyers was the change from "occurrence" to "claims-made" policies, and the fact that DWL provisions also appeared in those policies\(^{27}\) received little attention.

2. Directors' and Officers' Liability Policies

D & O policies for corporate boards became common during the 1980s in response to the rise in litigation involving those boards. By 1982, a corporate survey regarding D & O liability showed an average total cost of $1,340,000 per claim of which an average $763,000 accounted for claim settlement or judgment and $577,000 for legal fees.\(^{29}\) The same survey showed suits by

\(^{24}\) Jane C. Taylor, Expenses Within Limit: A Reinsurer's Prospective. Address at the American Bar Association National Legal Malpractice Conference (Spring 1991).

\(^{25}\) Id.

\(^{26}\) Id. One writer notes that in the competitive market of the late 1970s, insurers offered policies that provided expenses in addition to the limit of liability and deductibles that only applied to loss just as the frequency and severity of claims increased. Carriers left the market and imposed DWL on their return. ZUTZ, supra note 1.

\(^{27}\) "Occurrence" policies covered the accident or injury that occurred during the policy term, even if the claim was not made until the policy expired. This meant claims could be made on the policy so long as the statute of limitations had not expired. The industry became adverse to the "long-tail" risk involved and switched its insureds to "claims made" policies which provided coverage only for those accidents for which a claim was made during the policy period.

\(^{28}\) ZUTZ, supra note 1.

\(^{29}\) The Wyatt Company, 1982 Comprehensive Report: Directors & Officers
stockholders to be the single largest source of the claims, followed by employee and customer suits. The same thing happened in the legal malpractice insurance arena where it has been said that "their [insurers] exposure was nearly as great in defending claims as it was in paying them."

Sitting alongside the expense ratio bottom lines were a few horror stories in which carriers had expended tens or hundreds of thousands of dollars for results, which both happily and unhappily, produced little or no liability payments. Even more disturbing were the increasing number of cases in which the defendant "won" but the carrier spent more than policy limits in producing the "victory."

It was because claims increased in frequency and size combined with defense costs that seemed unpredictably large which prompted the insurance industry to market D & O policies which are relevant to our discussion by reason of three peculiar characteristics. First, they generally do not provide for any duty to defend. However, they do include the insured's defense costs on the definition of covered "loss" for indemnity purposes. The insured corporation or board member which is sued must defend and seek reimbursement under the indemnification language of the policy.

Second, D & O policies may be indemnity policies and not liability policies. Thus, the insurer may have no duty to pay a judgment or verdict until the insured has paid it and sought reimbursement under the policy's promise to indemnify. Third, and most importantly for our inquiry, the policies are DWL policies insofar as the defense costs will reduce the limit of liability coverage available. These characteristics probably reflect the "unending controversy" that has developed between insurers and insured directors and officers in deciding whether to defend the variety of potential claims pressed against corporate boards. The carriers have simply avoided the issue of whether to defend by letting the insured defend and seek

Liability/Fiduciary Liability 45 (1982), reported in Bisceglia, supra note 12, at 694.
30. Id. reported in Bisceglia, supra note 12, at 693.
31. ZUTZ, supra note 1.
32. Id.
34. Borden et al., supra note 2, at 93.
35. Id.
36. Id.
37. Bisceglia, supra note 12, at 707-08.
reimbursement later. Because D & O policies have been covering corporate losses for at least two decades, we will see that many of the pivotal decisions involving DWL arise from D & O coverage.

3. Commercial General Liability Policies

In 1985, the Insurance Services Office, Inc. ("I.S.O."), the trade organization for the casualty insurance industry, developed a Commercial General Liability ("CGL") policy that featured defense within limits. This was popular with the insurers who were struggling under the impact of the mass toxic tort cases and the many coverage issues the cases raised. Costs of defense in that arena were also skyrocketing. However, insurance consumers, marketing intermediaries and insurance regulators opposed DWL in the CGL policies so that the I.S.O. eventually withdrew the form. Some states adopted rules disallowing DWL or allowing such policies only on approval of the state's insurance commissioner. Nevertheless, DWL has become commonplace in the professional liability errors and omissions policies. Also, the statutory prohibitions against DWL generally do not apply to manuscript policies that are written for large insureds, so DWL provisions commonly exist in the CGL insurance covering many corporations.

B. Reasons for Development of the DWL Policy Provisions

1. Perspective of the Primary and Excess Insurers.

Insurers developed the DWL policy because of the increasing and uncertain cost of defense. To see the problem, one need only look at the defense costs involved in DWL cases that are the subject of appellate court decisions. In Biomass One v. Imperial Casualty and Indemnity Co., the policy contained a $2 million liability limit and the defense fees and costs were $1.9

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39. *Id.*
40. *See discussion infra, Part VII.*
million. In Okada v. MGIC Indemnity Corporation, the "per loss" limit was $1 million and the costs of defense were in excess of $1 million. In Helfand v. National Union Fire Insurance Co., the defense costs were $1.5 million on a $10 million policy. Harnischfeger Corporation v. Harbor Insurance Co. involved an aggregate limit of $3 million and litigation expenses of $1,230,141. Legal expenses exceeded the $2 million policy limit in Bankers Trust Co. v. Old Republic Insurance Co. In some of these cases, attorneys' fees that rivaled or exceeded the liability limit for indemnity gave rise to issues involving DWL. Consequently, uncertainty about defense costs and their mounting size has prompted insurers to limit that part of their promise to the insured.

Primary insurers whose policies do not contain DWL provisions have the problem of freeing themselves from the unlimited duty to defend when potential damage claims will clearly exhaust the liability limits of their primary coverage and extend to the excess coverage. If the damage claim will clearly exceed the primary insurer's limit of liability, but the case cannot be settled because the excess carrier and claimant cannot agree, the primary insurer with a limitless duty to defend may expend defense fees far exceeding its liability limits.

In Bankers Trust, Imperial Casualty and Indemnity Company had primary limits of $2 million. The company incurred more than $2 million in legal expenses defending the claim while the insured engaged in coverage litigation with the excess insurer. When the claim exceeds the limit of the primary insurer's liability, the primary insurer may find it is defending for the benefit of the excess carrier and cannot escape because the promise to defend under the basic insuring agreement is nominally unlimited. In such cases, it inures to the benefit of the primary carrier to have DWL provisions, so defense expenses can serve to exhaust the limits of the primary carrier's policy and trigger the obligations of the excess carrier.

The company providing excess coverage also has an interest in issues of DWL. If the primary insurer can count its defense costs toward exhausting its policy limits, it may be able to exhaust quickly and trigger the excess carrier's coverage.

43. 823 F.2d 276, 279 (9th Cir. 1987).
45. 927 F.2d 974, 975 (7th Cir. 1991).
46. 7 F.3d 93, 94 (7th Cir. 1993).
47. Id.
Unless the primary policy has clear DWL provisions, the excess carrier will argue that the primary policy cannot be exhausted by defense costs so as to trigger the excess insurer's duties. In Coleman Company, Inc. v. California Union Insurance Co., the insured had a primary policy which clearly included defense costs in calculation of the limit of liability. Its excess insurer provided $1.5 million insurance that was “follow form” to a $1 million primary policy provided by Commercial Union. The excess policy provided that no obligation to defend was included in the limit.

The question, then, was whether the defense costs could be used by the insured and primary carrier in calculating the point at which the excess coverage attached. The court noted that the excess policy was “following form” and held that the intent was to consider the underlying (DWL) policy in determining the coverage under the umbrella policy. Hence, the defense costs of the primary insurer could be used to calculate the exhaustion of limits that triggered the excess coverage.

In Harnischfeger, Harbor Insurance Company sold excess insurance policies to Harnischfeger on the express condition that the coverage “shall not attach unless and until [Harnischfeger or its insurer] shall have paid the amount of the underlying limits on account of such occurrence.” The underlying limit agreed upon was $3 million. Harnischfeger insured under self-retention and contracted with Wassau to administer its insurance fund and adjust claims with a $3 million limit on Wassau's outlay in doing so. Harbor’s excess policy had a “limit of liability” clause that limited Harbor’s liability to “Ultimate Net Loss” and defined that loss to include “expenses for doctors, lawyers, nurses and investigators and other persons, and for litigation, settlement, adjustment and investigation of claims and suits.”

Harnischfeger claimed that the $3 million administrative expense of Wassau counted to exhaust its self insured retention and triggered Harbor’s duties under the excess policy. The excess carrier obtained a summary judgment which was affirmed by the Seventh Circuit. The appellate court held that Harbor had no duty to pay until Harnischfeger had expended $3

48. 960 F.2d 1529, 1531 (10th Cir. 1992).
49. Id. at 1534-35.
51. Id.
million in indemnity, not defense costs, reasoning that the Ultimate Net Loss language was part of the limit of liability clause and not the loss payable clause.\(^{52}\)

On the other hand, if the primary policy provides DWL, issues may arise as to whether the excess coverage is also DWL. Insurance binders under which the excess carriers agree to provide coverage do not always make a clear joining of coverages. The insurance binder may use the words "follow form" to indicate that the excess insurance follows the form of the primary policy which is likely a derivative of a form produced by the I.S.O. However, the insurance binders also make free reference to I.S.O. forms as a simple method of specifying the coverage. Hence, ambiguity may develop as to whether the excess insurer is following form and covering under DWL provisions or providing coverage under I.S.O. standard forms.

In *Asplundh Tree Expert Co. v. Pacific Employers Insurance Co.*,\(^{53}\) Pacific provided excess insurance in the amount of $500,000 under an insurance binding agreement with Asplundh. The insurance binding agreement provided that Asplundh had a $500,000 annual self insured retention that included defense, settlement and supplementary payments. In essence, Asplundh self-insured as the primary carrier under a DWL policy. The insurance binder provided that Pacific would provide "$500,000 aggregate excess of the limits described"\(^{54}\) in Asplundh's retention. However, the excess insurance binder also incorporated and referenced coverage under I.S.O. forms that provided standard liability coverage, not DWL.

When Asplundh suffered $874,288.83 in product liability claims and defense expenses, it submitted the $374,288.83 excess over its $500,000 self-insured retention to PEIC under the excess insurance binder. PEIC paid that amount (which included defense costs) from its $500,000 limit (which it treated as DWL), and then sent to excess insurer, National Union, $125,711.17 contending that amount represented the balance of its $500,000 obligation to defend and indemnify Asplundh. National Union refused, contending that PEIC had to continue defending claims against Asplundh, regardless of cost, until PEIC's $500,000 limit was exhausted by indemnity claims not

\(^{52}\) *Id.*


\(^{54}\) *Id.* at *7.*
including defense costs.

Asplundh brought an action for bad faith for PEIC's failure to continue paying defense costs under its promise, and PEIC moved to dismiss on the ground that its coverage was "follow form" to Asplundh's DWL provisions. The court found the insurance binder ambiguous, noting that the interpretation of Asplundh and National Union was a reasonable one and refused to grant PEIC's motion to dismiss plaintiff's claims that PEIC had a continuing duty to defend.

Hence, excess carriers may litigate the issue of whether defense costs can be counted towards exhausting the primary carrier's limits, and triggering the excess carrier's duty to perform. On the other hand, reinsurers, those companies insuring the primary insurers against claims too big in size and number for the primary insurer to financially handle, favor DWL provisions for several reasons. First, insurers who carry primary lines, such as legal and medical malpractice insurance, are often captive companies who carry only one line of insurance and cannot pull out of bad markets. Risk of losses from variance of legal climate, cannot be spread among different lines and this creates risk to the primary insurer and ultimately the reinsurer.

Second, DWL "dampens volatility" of lines like legal malpractice insurance making losses more predictable and the reinsurer's pricing easier. Third, in an era in which expenses of defense often exceed indemnity payments, the primary insurer cannot rely on the reinsurer until the indemnity limits of primary insurance are exhausted. While the reinsurers could agree to respond when expenses reach a certain level, they would rather have the expenses included in the indemnity limit for better certainty and predictability.

Fourth, DWL may discourage insureds from relying on an unlimited duty to defend and failing to purchase adequate insurance. The theory is that such insureds will have to be more realistic in assessing the necessary limits if they know that defense expenses are deducted from the limit of indemnity. Reinsurers want to avoid potential inadequate coverage for bad faith or excess claims that may affect the reinsurer.

55. Taylor, supra note 24.
56. Id.
57. Id.
58. Id.
59. Id.
Fifth, DWL avoids the problem of the "fight at all costs" approach that an insured may adopt if the insurer has an unlimited duty to defend. Finally, reinsurers view DWL as increasing the security of the primary insurers who are their clients by reducing their risk, increasing predictability and thereby buttressing their financial condition, all of which inures to the benefit of the reinsurers.

2. Perspective of the Insured

At first glance, it is hard to see how DWL policies benefit insurance consumers. When the professional liability insurers notified insureds of the change to claims-made policies in the 1980s, they also inserted DWL provisions. Hence, a nominally unlimited duty to defend was changed to provide expenses of defense only insofar as they fit in the limit of money available for indemnity. It may be true that the nominally unlimited policy was, in the arena of professional liability insurance, only a recent creation, having been developed in a competitive soft market in the late 1970s. Nevertheless, adopting DWL in the 1980s resulted in what amounted to a significant reduction in coverage for consumers, and it is doubtful that there was a correlative decrease in rates. Insurers would argue that they had to adopt DWL because expenses in defending claims were rivaling losses paid. This is no doubt true considering the complexity of defending, under professional malpractice policies and D & O policies, huge claims arising out of such events as the savings and loan failures and toxic spills.

However, one wonders whether the situation in which defense costs equal or exceed loss payments is really anything new. When the average loss was $10,000, it was likely that average defense costs were also $10,000. It is equally likely that the real problem is the size of the claims. When claims under CGL policies were $10,000 or $100,000, insurers were probably prepared for defense expenditures in equal amounts, but that was not so when the limits and the claims were $1,000,000 or more.

By the 1980s, the policy limits purchased for predicted liability protection had simply grown to a size where the insurers were unwilling to make an equal commitment for risk.

60. Id.
61. Id.
62. ZUTZ, supra note 1.
of defense expenditures. The insurers want to limit their exposure with some certainty.

Before DWL, the insured assessed likely risk exposure in terms of predicted losses and contracted accordingly for appropriate limits of liability. Sophisticated insureds may have appreciated the fact that they were also purchasing the insurer’s duty to defend, though it is unlikely that they truly appreciated the fact that the duty was virtually unlimited. The emergence of DWL provisions meant that consumers of D & O coverage and of professional liability coverage shouldered the dual burden of evaluating the potential costs of defense, as well as potential loss payable, in order to decide the appropriate limit of liability for their casualty insurance. When the insurers adopted DWL, they, in essence, transferred to the insureds the unlimited and unpredictable risk involved in costs of defense.

Whether this involved any tangible benefit to the insured is questionable. Industry asserts that the insured can obtain significant savings by purchasing DWL policies. However, such assertions must be tested against the fact that the insured must purchase higher indemnity limits to cover the amount deducted for costs of defense. Given the experience of the industry, an insured under professional liability or D & O coverage would be prudent in assuming that defense expenses will equal losses payable, so that the net affect of a change to DWL is the necessity of doubling one’s liability limits. If law firms, medical firms and corporate boards did not do so in the 1980s when DWL was adopted, it is likely because they were focused on and concerned with the perceived impact of the forced switch to claims-made policies and did not appreciate the import or even the existence of DWL provisions in their policies.

Theoretically, if that part of the industry consisting of captive and single-line insurers offering professional errors and

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63. 36 of the 48 insurers providing legal malpractice insurance offer limits of at least $10 million, one as much as $125 million per claim and $250 million aggregate. See chart included as an appendix to, Selecting Legal Malpractice Insurance, Standing Committee on Lawyer’s Professional Liability.

64. Id. Thirty eight of the forty eight legal malpractice insurers include now defense costs within their limits.


66. Surveys conducted by the author at Continuing Legal Education programs for lawyers indicate that more than half do not know that their Errors & Omissions policies are DWL, and consequently, have not taken expenses of defense into account in selecting their limit of liability.
omissions ("E & O") coverage and D & O coverage were prohibited from using DWL policies, they would have to greatly increase premiums to cover the unpredictability of costs of defense in the high limit policies of today or be forced to pull out of the market. Hence, they argue, the insurance consumers will either pay a greatly increased premium for the unfettered duty to defend; pay a lesser premium for DWL (which means purchasing a policy with higher limits and thereby incurring additional premium expense); or face a market in which the insurance is not available. However, at least one actuary asserts that there is no actuarial need for DWL provisions in liability policies because actuarial rate making procedures allow pricing of such policies at a profitable level without deducting defense costs from the limit. Nevertheless, one way or the other, the argument goes, "the consumer is going to pay for the losses and expenses." The real question is whether any savings realized as a result of DWL policies are passed on to the insurance consumer.

V. POTENTIAL CONFLICTS OF INTEREST

There are, inherent in DWL policies, marketing and provision of benefits and potential legal problems, especially conflicts of interest, that may ultimately make them risky for insurers as well as insureds. There are the questions about whether the insured knows the policy is defense within limits. New issues about control of the defense arise under DWL policies as well as issues of what triggers a duty to settle under a policy whose limits can be liquidated by the defense costs. DWL policies can present conflicts for the plaintiff's attorney whose decision to aggressively represent the claimant may exhaust the policy. They can present conflicts for insurance defense counsel who intends to defend a risk averse client who prefers to save the limit of liability for settlement. These are conflicts and problems that present risks to the carriers, their insureds and their respective counsel. Each potential problem merits some discussion here.

68. ZUTZ, supra note 1.
A. Risk of 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 that deducts the entire cost of defense from the liability limit, a potential for intentional or negligent misrepresentation exists 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.

The state of Oregon requires that the DWL policy form give notice that defense costs are deducted from the limits available for liability.69 A policy containing representations about liability limits and 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.70 In Branning v. CNA Insurance Co.71 the court found the insurer's purported DWL provisions ambiguous because construing the policy to be DWL required juxtaposition of "three different clauses appearing on different pages."72 The court cited the fact "that a purchaser of insurance could reasonably review this policy and not be aware that the insurer sought to deduct defense costs from the limit of liability."73 Hence, the doctrine of reasonable expectations may apply to provide the insurance consumer indemnity coverage not subject to reduction for defense expenditures.

B. Rights and Duties of the Parties Under the DWL Policy

The dynamics between insured and insurer change substantially when the insured seeks defense and indemnification under a DWL policy. Under standard policies,

72. Id. at 732.
73. Id. at 733.
defense of most claims does not involve a conflict between the insured and the insurer. Insurance defense counsel traditionally advise the insurers they represent that counsel owes his or her primary duty to the insured and give little weight to costs of defense in determining the best course of action in defending or settling the case. Indeed, insurers attempts to control the defense and costs of defense have been held to be the unauthorized practice of law.\textsuperscript{74} Counsel zealously defends the insured, does not consider the interests of the insurer, and takes no actions adverse to the interests of the insured.\textsuperscript{75} When the occasional claim arises in which a conflict exists between the insurer and the insured, defense counsel recommends that the insurer retain separate counsel to represent its interests or, in the case of many coverage disputes, recommends the insurer issue a reservation of rights letter and inform the insured that the insured may wish to seek the advice of independent counsel.

As stated by Windt:

The first thing that an insurer with a duty to defend must determine after receiving notice that a suit has been filed against one of its insureds is whether there is a conflict of interest between it and the insured with regard to how the lawsuit should be defended. If there is no such conflict, the insurer can hire counsel to represent both the insured's and the insurance company's interests in the litigation. If, however, there is such a conflict, the insurer should consider either hiring "independent" counsel to represent the insured or allowing the insured to select private counsel.\textsuperscript{76}

Under the DWL policy, 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.

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 seek to defend on

\textsuperscript{74} In re the Rules of Professional Conduct, 2 P.3d 806 (Mont. 2000).
\textsuperscript{75} 1 \textsc{Allan D. Windt}, \textsc{Insurance Claims \\& Disputes} § 4.19, at 217 (3d ed. 1995).
\textsuperscript{76} \textit{Id.} § 4.20, at 218-19.
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 the risk that a hard fought defense will deplete the limits and block settlement later or leave an unsatisfied judgment. On the other hand, it may be in the insurer’s interest to establish through a hard fought defense that “nuisance” claims will not invoke any settlement offers from this insurance company. Hence, a conflict is born.

While prudent insurance defense counsel have traditionally kept the insured informed of settlement offers, they have not provided information to the insured on costs of defense. Because the insured now must evaluate risk of loss and risk of defense costs, the situation is more complex, so it may be necessary that defense counsel now 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. 77

C. Reservation of Rights

Before discussing settlement offers under DWL policies, let us consider problems arising in coverage disputes. Courts have used different approaches to the duty owed the insured by the insurer where the insurer believes that a claim for which the insured demands indemnity and defense does not fall within the policy coverage. Unless the claim on its face is clearly outside the coverage, the insurer questioning coverage but exercising prudence will provide the insured with a reservation of rights and proceed with the defense.

However, there is variation in the duty courts place on the

77. Rosenberg, supra note 67, at 460-51.
Some allow an insurer to refuse defense and still preserve the right to later litigate the coverage issue after the insured has conducted the defense. This leaves the insured bearing the costs of defense unless a court should ultimately decide later that the insurer was responsible. Other courts decide that, in the face of a coverage conflict, the insurer must defend, but that neither insured nor insurer are foreclosed from subsequently litigating the coverage issue. This leaves the insurer bearing the costs of defense with little hope of recouping the costs if the court ultimately decides no coverage existed. The problem is that the insurer which undertakes the defense in the face of a coverage dispute is ethically bound not to act in its interest to the detriment of the insured by developing through fact investigation or discovery the facts necessary to prove lack of coverage. Consequently, a third line of decisions would forbid the insurer in the coverage dispute from undertaking the defense of the insured, but would require that the insurer pay the costs of defense and provide the insured an independent counsel. In California this procedure is statutory.

There is no conflict if the insurer elects to defend unconditionally, without reservation of rights, since estoppel will later prevent the insurer from withdrawing defense. 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 to withdraw when defense expenditures exceed the limits of liability. This raises the question whether giving notice that a claim will not likely be covered by the limits is any different than giving notice that a claim might not be covered by the policy language.

If the insurer defends under reservation of right to withdraw when the policy limit is exceeded, is it not defending...
under a conflict insofar as it may provide a token defense, or
provide a "win at any cost" (therefore exhausting the limits)
defense while failing to work for the lowest possible settlement?
How is this different from situations in which it is deemed best
to allow the insured to select independent counsel?

Windt asserts that issuance of a reservation of rights does
not necessarily mean that a conflict exists such that the carrier
will lose the right to select counsel. He states that a conflict
exists only if a coverage issue will later be determined by facts
in the lawsuit being defended and the outcome can be controlled
by defense counsel. But, he notes that a conflict can arise with
regard to the conduct of the insured's defense:

Specifically, a conflict over the existence of coverage will serve to
create a conflict of interest with regard to the insured's defense
when the insurer's potential liability could be reduced if the
insured were defended in a particular manner.

As an example, he cites the situation where plaintiff has
plead alternate theories of negligence and intentional conduct
and it would be in the insurer's interest and against the
insured's interest to develop facts showing that the conduct was
intentional. Such a conflict would require that the insured
select independent counsel.

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
insurance counsel may quickly deplete the policy limit and allow
the insurer to withdraw leaving the indemnity limit exhausted
and the insured exposed. There is no conflict under a standard
liability policy where the insurer has issued a reservation of
rights letter warning that the claim exceeds the policy limit.
Theoretically, defense counsel will not do anything in that
situation to adversely affect the insured's liability. However,
that changes when the defense costs are subtracted from the
indemnity limit.

Under DWL, 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 to the

85. Id. at 220.
86. Id. at 221.
87. Id. at 222.
89. 1 Windt, supra note 75, § 4.20, at 225.
insured the right to select counsel unless the limit is so substantial that there is no potential to exhaust it. The risk to the carrier who “acts wrongfully in connection with satisfying its duty to defend” is the potential for being “estopped from denying coverage” beyond the limit.\textsuperscript{90} For the insurer, this can be a grave risk.

For example, in Okada v. MGIC Indemnity Corporation,\textsuperscript{91} members of the board of directors of a failed savings and loan institution brought action for declaratory judgment and bad faith against the insurer for failing to pay defense costs and to participate in settlement. The insurer had been paying legal expenses of the directors as they became due in a civil action brought by the Federal Savings and Loan Insurance Corporation (“FSLIC”) and the First Hawaiian Bank against the directors. The FSLIC and bank were pressing shareholder direct and derivative actions they obtained by assignment.

MGIC, the D & O insurer, insisted on defending under reservation of rights on the apparent ground that some of the claims against the directors were covered and some were not. The policy provided that the insurer would pay “all Loss which the Directors and Officers . . . shall become legally obligated to pay” and defined “Loss” to include “costs . . . and defense of legal actions.”\textsuperscript{92} However, provision 5(a) of the policy provided: “No costs, charges and expenses shall be incurred or settlements made without the Insurer’s consent which consent shall not be unreasonably withheld; however, in the event such consent is given, the Insurer shall pay, subject to the provisions of Clause 4, such costs, settlements, charges and expenses.”\textsuperscript{93} Provision 5(c) then gave the Insurer discretion to advance “expenses” incurred by the directors but provided “always that in the event it is finally established the Insurer has no liability hereunder, such Directors and Officers agree to repay to the Insurer, upon demand, all monies advanced by virtue of this provision.”\textsuperscript{94}

For two years, MGIC paid the attorneys’ fees as they became due while reserving the right to contest coverage and to demand repayment if it was later ruled that the claims were not

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{90} \emph{Id.} § 4.22, at 231 (\textit{citing} Shelby Steel Fabricators, Inc. v. United States Fidelity & Guar. Ins. Co., 569 So. 2d 309, 312-13 (Ala. 1990) (for the “implication” that the insurer will be automatically estopped from denying coverage)).
\item \textsuperscript{91} 823 F.2d 276, 277-79 (9th Cir. 1987).
\item \textsuperscript{92} \emph{Id.} at 278.
\item \textsuperscript{93} \emph{Id.} at 279.
\item \textsuperscript{94} \emph{Id.}
\end{itemize}
\end{footnotesize}
covered. After two years, some of the directors demanded unconditional payment of defense costs asserting that the policy was a liability policy and not an indemnity policy. MGIC refused contending that its discretion in payment of "expenses" under 5(c) meant that it had no duty to pay defense costs contemporaneously with damages and could withhold them pending ultimate determination of coverage under the reservation of rights. The court held that the costs of the "defense of legal actions" included in the definition of loss were not clearly contained in the "expenses" which were subject to the insurer's discretion in payment under provision 5(c). Consequently, the court found the insured could have had a reasonable belief that the policy provided contemporaneous payment of defense costs and ruled that this was the insured's right. However, the court upheld the insurers' right to repayment under the reservation of rights in the event of an ultimate finding of no coverage. Further, the court said that MGIC must apportion costs, since they had no duty to pay defense costs on uncovered claims.

D. Control of the Defense

In a standard policy case, the insured who retains independent counsel to undertake defense in a coverage dispute may have little incentive to keep defense costs down other than the possibility that the court will find no coverage later on. To defend the claim, the insured may retain lawyer specialists whose costs may be extremely high. Under a DWL policy, the insured, proceeding in its own defense, has a direct interest in keeping the attorneys' fees at a minimum and in controlling the defense. If the insurer refuses to defend, the insured will contend this is a bad faith breach. If the insurer defends, the insured may fault the decision to defend instead of settling. Many insurers offering D & O 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.

E. Duty to Settle

Once the 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.

In 1962 the Federal District Court in the District of Montana, in Jessen v. O’Daniel, 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 1958 landmark case, Comunale v. Traders & General Insurance Co., 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 in that case stated that in determining whether to settle, the insurer must give the

95. For example, standard professional liability policies use this language: “The company may make such investigation and settlement of any claim or suit as it deems expedient.” See, e.g., MILLER’S, supra note 3, Physicians, Surgeons and Dentists Professional Liability Insurance (Claims Made) Form GL 00 22 03 81, form PLPS3, provision 1C2 at 453.4; Lawyers Professional Liability Insurance (Claims Made) Form GL 00 24 03 81, form PLLP3, provision 01C2, at 454.0 and Hospital Professional Liability Insurance (Claims Made) Form GL 00 21 03 81, form PLHP2, provision 1B2, at 454.3.

The standard commercial coverage forms provide: “We may at our discretion investigate any ‘occurrence’ and settle any claim or ‘suit’ that may result.” See, e.g., Id., Commercial General Liability Form CG 00 02 10 93, form CGGL2, provision 1A1f, at 421.

The standard business auto policy forms provide: “We may investigate and settle any claim or ‘suit’ as we consider appropriate.” See, e.g., Id., Business Auto Coverage Form CA 00 01 12 90, form CABAP, provision 2A4c, at 260; Garage Coverage Form CA 00 05 07 97, form CAGAP, provision 2A3c, at 271; and Truckers Coverage Form CA 00 12 07 97, form CATRP, provision 2A4c, at 286. The standard personal auto policy provides: “We will settle or defend, as we consider appropriate, any claim or suit asking for these damages.” See, e.g., Id., Personal Auto Policy Form PP 00 01 06 94, form PAP, provision A1A3, at 2. The standard homeowner’s policy provides: “We may investigate or settle any claim or suit that we decide is appropriate.” See, e.g., Id., Homeowners 3 Special Form HO 00 03 04 91, form HO, provision 1.1 E6ia, at 204, and Farmers Comprehensive Personal Liability Form HO-73 (Ed. 4-80), form HOFAR, provision 2.1 E1b, at 248. Note that professional liability coverage forms from 1973 provided for settlement only with consent of the insured as follows: “... and may make such investigation and, with the written consent of the insured, such settlement of any claim or suit as it deems expedient.” See, e.g., Id., Physicians, Surgeons and Dentists Professional Liability Insurance Form GL 00 11 01 73, Form PLPS1, provision 1B2, at 453.1, and Form GL 00 20 08 61, form PLLP1, provision A2a, at 453.6. These forms are out of use and have not been offered insureds since the late 1980s.

96. See generally, ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW, § 7.8(a) (Practitioner’s ed. 1988).


interests of the insured "at least as much consideration as it
does to its own interests;" and "[w]hen there is great risk of a
recovery beyond the policy limits so that the most reasonable
manner of disposing to the claim is a settlement which can be
made within those limits, a consideration in good faith of the
insured's interest requires the insurer to settle the claim." 99 In
Crisci v. Security Insurance Co. of New Haven, Connecticut,100
the court said 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."

If, in its discretion, the insurer chooses not to settle, and the
verdict falls within policy limits, the only real detriment to the
insurer will likely be the insurer's indemnification of the insured
by payment of the loss within the limit. If, on the other hand, a
verdict is returned in excess of the policy limits, the insurer is
exposed to risk of excess coverage by reason of bad faith failure
to settle. Factors to be considered in determining whether the
insurer should be liable for the excess by reason of bad faith
were set forth in Jessen v. O'Daniel:

Factors to be considered include (1) whether, by reason of the
severity of the plaintiff's injuries, any verdict is likely to be greatly
in excess of the policy limits; (2) whether the facts in the case
indicate that a defendant's verdict on the issue of liability is
doubtful; (3) whether the company has given due regard to the
recommendations of its trial counsel; (4) whether the insured has
been informed of all settlement demands and offers; (5) whether
the insured has demanded that the insurer settle within the policy
limits; (6) whether the company has given due consideration to
any offer of contribution made by the insured.101

In Okada v. MGIC Indemnity Corporation,102 the court
overturned a summary judgment for bad faith failure to enter
settlement negotiation granted the insured by the trial court.
While the insurer had spent $1 million in defense of the claims,
potentially exhausting the $1 million limit of the DWL policy,
there were disputed issues of fact with regard to whether MGIC
participated in settlement. The appellate court said the "breach
of a duty to settle in good faith depends on the reasonableness of
the insurer's conduct"103 and reversed the summary judgment.

99. Id. at 201.
100. 426 P.2d 173, 176 (Cal. 1967).
102. 823 F.2d 276, 283 (9th Cir. 1987).
103. Id.
Jessen v. O'Daniel and its progeny were decided without regard to modern DWL policies. It would be consistent today for a court to add as a factor for consideration whether failure to settle will result in the indemnity limit being exhausted for purposes of indemnifying against a verdict or for purposes of later settlement negotiations. Hence, the duty to settle may involve more factors and be more complex for the insurer defending under a DWL policy.

F. Demand for Settlement Within the Policy Limits

Consider the problems raised when a plaintiff demands settlement within policy limits on a DWL policy. Insurers take demands for policy limits seriously, since their rejection is considered tantamount to declaring the policy limitless.\textsuperscript{104}

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 defense costs reasonably likely to be expended.

For instance, suppose the insurer has issued a legal malpractice policy with DWL provisions with a $100,000 limit of liability coverage. The policy applies to cover a situation in which the insured lawyer and the injured plaintiff shared equal blame for failing to file a case within the statute of limitations. Suppose also that plaintiffs underlying personal injury damages were $100,000, and defense costs could reasonably be expected to be $50,000.

Would the insurer have any duty to accept a demand for settlement of $50,000? Would the insurer be liable for excess verdict, if it spent $50,000 defending the claim and suffered a verdict of $100,000 ($50,000 over the balance remaining on the policy limit)? If the insurer's own evaluation of the case reflected a belief that the loss value, assuming 50\% comparative negligence, was $50,000, and the costs of defense would exceed $50,000, would it have an obligation to accept an offer of

\textsuperscript{104} While case law sets out "prudent insurer" tests in such cases as \textit{Crisci}, 426 P.2d at 176, the strict liability suggestion of cases such as \textit{Comunale}, 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.
DEFENSE WITHIN LIMITS

settlement of $100,000? If an insurer that had no DWL provisions in its policy turned down a $50,000 offer and suffered a verdict in excess of the limit, it would surely be held liable for the excess.

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 matter of time before such issues emerge as DWL provisions are litigated.

G. The Conflict for the Plaintiff’s Attorney

DWL policies do not only present conflicts and problems for insurance defense counsel; the plaintiff’s attorney faced with a tortfeasor insured under a DWL policy must also use care in proceeding to recover against the insured. Many plaintiffs’ lawyers find an aggressive litigation approach to be an effective method for inducing the defense to offer settlement. Some have a policy of filing suit immediately and pursuing pretrial discovery without negotiating until the defense feels compelled to offer settlement or tender the limits of the available insurance.

If the available insurance contains DWL provisions, however, such tactics 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 agreements 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 has a duty to limit 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 limit 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 especially if the insured has independent counsel monitoring the decisions of
H. 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:

Where an insurer, without reservation and with actual or presumed knowledge, assumes the exclusive control of the defense of claims against the insured, it cannot thereafter withdraw and deny liability under the policy on the ground of noncoverage, prejudice to the insured by virtue of the insurer's assumption of the defense being, in this situation, conclusively presumed . . . the loss of the right of the insured to control and manage the case is itself prejudicial.

In Transamerica Insurance v. Chubb and Son, Inc., the court held that the insurer that defended for ten months was estopped to deny coverage for three reasons. First, before backing out of the case, the company had undertaken and conducted the defense for ten months, thereby depriving the insured "of their valuable right to retain private counsel." Second, if the insured were not protected by the policy, they then "had the right to arrange for the initial investigation, settlement negotiations, and the conduct of the law suit [sic]." Third, there was a potential conflict of interest on the part of the retained defense attorney vis-a-vis the insured.

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:

The company shall not be obligated to pay any claim or judgment or to defend or continue to defend any suit after the applicable limit of the company's liability has been exhausted by payment of

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105. Consider the insurer's position if plaintiff's counsel writes the insurer or their counsel a letter (1) reciting the facts of the conflict caused by the refusal to settle within policy limits and the decision to expend considerable defense costs, (2) inviting the insurer to give full notice of the conflict situation to the insured, and (3) asking the insurer to have the insured's independent counsel contact the plaintiff's attorney so they can explore ways of protecting the insured.


108. Id. at 1083. See also, Beckwith Machinery v. Travelers Indem., 638 F.Supp. 1179, 1186 (W.D. Pa. 1986); Safeco, 725 P.2d at 221.

109. Transamerica Ins., 554 P.2d at 1083.

110. Id.
judgments, settlement or CLAIMS EXPENSES.\textsuperscript{111}

However, even under a DWL policy, withdrawal may sometimes be thwarted. Courts may estop insurers from withdrawing even when they have the policy rights to do so in the following categories of cases:\textsuperscript{112} (1) where the case is so near trial as to prejudice the insured in its defense if the insurer withdraws; (2) where the insurer, in the course of defending, has done something that prejudices the insured in its defense, or (3) where the insurer has already defended the insured over a substantial period of time.\textsuperscript{113}

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 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.\textsuperscript{114} The only duty of the insured at that point is to cooperate; the insured need not minimize the insurer's exposure.\textsuperscript{115}

VI. ENFORCING DWL PROVISIONS

Several courts have grappled with issues of whether particular insurance policies provide defense within limits. While professional liability policies and D & O liability policies have long contained express DWL provisions, the courts have recently entertained disputes about whether certain CGL policies provide defense within limits. Emergence of such issues in the courts probably reflects the size and number of claims\textsuperscript{116}

\begin{footnotesize}
\textsuperscript{111} M\textsc{iller,}\textsc{'s, supra note 3, Lawyers Professional Liability Insurance Form GL 00 24 03 81, form PLLP3, provision 01C3, at 454.0.}
\textsuperscript{112} 1 W\textsc{indt, supra note 75, § 4.30, at 248.}
\textsuperscript{113} See, e.g., Safeco, 725 P.2d at 221; Beckwith Machinery, 638 F. Supp. at 1186.
\textsuperscript{114} 1 W\textsc{indt, supra note 75, § 4.18, at 214.}
\textsuperscript{115} Id. at 215.
\end{footnotesize}
that arose during the 1980s from the savings and loan collapse, toxic torts and the concomitant magnitude of the costs of defense involved in such cases. Simply put, the issue became who would pay for the enormous costs of defense involved in those phenomenal claims.

Not surprisingly, some carriers faced with historically unprecedented and unpredicted losses and costs of defense, attempted to read DWL provisions into standard CGL policies. In *Bankers Trust v. Imperial Casualty and Indemnity*,

Bankers Trust won a tort judgment against Lee Kelling & Associates (LKA) for $12.88 million. Imperial, which provided primary commercial general liability coverage to LKA with $2 million limits, incurred more than $2 million in legal expense in defending LKA in the underlying action. Imperial, apparently staggered by the cost of defense, took the position that those costs counted toward the $2 million limit of liability and sought a court declaration that its coverage was exhausted. The federal district court disagreed and Imperial appealed.

On appeal, Judge Easterbrook succinctly stated the predicament that prompted Imperial to insist that its CGL policy provided DWL:

> Under most policies, the costs of defense are nominally unlimited, although the stakes of the case set an implicit limit: an insurer will expend only a fraction of its total exposure, for the alternative is to tender the policy limits in settlement. A primary insurer's choice may be complicated, however, when there is excess insurance, for the policies may interlock in a fashion that requires the primary carrier to put on a defense that will inure to the benefit of the excess carriers, or when state law requires an insurer to go on defending even after paying the policy limits. Apparently one or the other occurred in Bankers Trust's litigation against LKA, for otherwise Imperial acted foolishly in paying lawyers more than $2 million trying to ward off a judgment that from Imperial's perspective could not exceed $2 million.

In fact, Imperial's policy appeared to be a standard CGL policy with a standard basic insuring agreement and "limits of liability" provision. However, the Declarations section of the policy provided: "The limit of liability afforded under the Policy shall be subject to the deductible amount (set forth below) which shall be applicable to 'each claim' and shall be inclusive of 'costs,
charges and expenses.”\textsuperscript{119} “Costs, charges and expenses” were defined in the policy to exclude the company’s adjustment expenses, but to include such items as attorney fees, court costs and expert expense.\textsuperscript{120} The court found this to mean only that legal fees in defense counted toward the deductible.

However, Imperial pointed to the fact that the definition of “damages” included “costs, charges and expenses.”\textsuperscript{121} The court noted the obvious, “damages” was not a term in the limit of liability but in the obligation to indemnify and meant only that Imperial had to pay any costs, charges and expenses if they were part of a judgment against their insured. The court refused to construe the policy provisions as DWL.

The court found Imperial’s reading of its policy to be less than candid:

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.\textsuperscript{122}

Noting that federal courts had, in unpublished decisions, ruled twice previously that Imperial’s CGL policies were not DWL,\textsuperscript{123} Judge Easterbrook wrote, “we publish this decision and

\textsuperscript{119} Id. at 95.

\textsuperscript{120} Id. stating:
The words “costs, charges and expenses” shall mean: legal expenses, excluding the cost of investigation and adjustment of claims by salaried employees of the Company and fee adjusters, but including attorney’s fees, arbitrator’s fees, court costs, expenses incurred in obtaining expert testimony and the attendance of witnesses and costs incurred in connection with arbitration proceedings against the Named Insured; provided only those items of expense which can be directly allocated to a specific claim involving litigation or possible litigation shall be included).

\textsuperscript{121} Id. stating:
The word “damages” shall mean: loss, judgments, settlements and “costs, charges and expenses”, provided always that such subject of damages shall not include fines or penalties imposed by law or other matters which may be deemed uninsurable under the law pursuant to which the Policy shall be construed).

\textsuperscript{122} Id. at 94.

\textsuperscript{123} Id. See also Biomass One, LP v. Imperial Cas. & Indem., No. 91-35197, 1992 U.S. App. LEXIS 17773, at *1 (9th Cir. July 20, 1992) (reported as Table Case at 968 F.2d 1220, 1992 U.S. App. LEXIS 23129).; International Ins. v. Imperial Cas. & Indem., No. CV 91 5494 JGD, 1992 WL 5447721 (C.D. Cal. Oct. 28, 1992), appeal docketed, No. 92-56551 (9th Cir.). The author notes that Ninth Circuit Rule 36-3 provides that dispositions other than opinions or orders designated for publication are not precedentual and should not be cited except when relevant under the doctrines of law of the case, res judicata, or collateral estoppel. This unpublished decision is cited here because its facts and discussion aid in the DWL analysis.
trust that Imperial will desist.”\footnote{7 F.3d 93, 95 (7th Cir. 1993).} It is noteworthy that the court did not award the insureds sanctions against Imperial even though Imperial had lost the issues twice previously in the unpublished decisions.

In *Biomass One v. Imperial Casualty and Indemnity Co.*,\footnote{1992 U.S. App. LEXIS 17773, at *1.} Biomass sued S-P Construction in a state court in Oregon. Imperial defended under a professional liability insurance policy and paid $1.9 million in defense costs while asserting that the policy was DWL so that the limits were essentially exhausted. S-P Construction settled with Biomass assigning its rights against Imperial. The Ninth Circuit Court of Appeals later reviewing the lower court’s conclusion that the policy was DWL, said, “No single sentence in the Imperial policy unambiguously states that defense costs shall be counted in determining when the policy limit is exhausted. Instead, the parties confront us with competing interpretations of a variety of the policy’s provisions.”\footnote{Id.} The court implied that DWL provisions were “provisions that serve to reduce or forfeit coverage” requiring that the insured be given specific and unequivocal notice.”\footnote{Id.}

The *Bankers Trust* and *Biomass* cases 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.

In their promise to indemnify the insured for liability to others, basic insuring agreements often define the loss for which they will indemnify the insured to include such things as attorney fees, court costs and interest on any judgment or award. Such definitions of loss or damage payable on behalf of the insured have provided an opportunity for insurers to claim that the language is meant to provide for DWL. However, the courts have only recognized the provisions as promises to indemnify if the insured has to pay attorney fees, court costs and interest to another party by reason of the insured’s liability to that party, and have ruled that the express provisions admit no interpretation that costs of defense are included in the limit of liability for loss payable.

This was the case in *Planet Insurance Co. v. Mead*
Reinsurance Corporation,\textsuperscript{128} where the insurer promised to indemnify for "Ultimate Net Loss" which was defined in the policy to include "(1) the sum paid . . . in satisfaction of the losses . . . (2) and includes attorney's fees, court costs and interest on any judgment or award, (3) but excludes all loss adjustment expenses and all salaries of employees and office expenses of the insured . . . ."\textsuperscript{129} The court refused the insurer's entreaties that the provision be construed to include defense costs, noting that the provision could be made consistent by construing it to mean that the insurer "is liable to the insured for Ultimate Net Loss in the same amount that the insured becomes liable to the plaintiff."\textsuperscript{130} In other words, if the insured has to pay a judgment including attorney fees, they are covered, but such is not the case with the insurer's costs of defending.

In \textit{Grunewald & Adams Jewelers, Inc. v. Lloyds of London},\textsuperscript{131} the policy provided for a $1,500 deductible that included "costs and expenses incurred . . . by or on behalf of the Assured."\textsuperscript{132} It further provided that the aggregate liability "(including costs and expenses as aforesaid)" could not exceed $25,000.\textsuperscript{133} Lloyds contended the provisions gave them the right to deduct from the $25,000 liability limit $12,000 in attorney fees spent defending the action which would leave only $13,000 for payment of the $25,000 settlement demand. While the lower court agreed with Lloyds, the appellate court reversed and ruled that costs of defense were included only in the deductible and not in the definition of aggregate liability.\textsuperscript{134} The court quoted with approval, language from the 1907 case of \textit{New Amsterdam Casualty Co. v. Cumberland Telephone & Telegraph Co.}:\textsuperscript{135}

If the Casualty Company should set [sic] fit to resist the claim, it could make any defense it pleased, hire such and as many lawyers as it wanted, and prolong the litigation to the last extremity. If its liability for the accident were converted into a fund for carrying on the contest, it could be done without the ordinary risks of litigation, and the only prospect for the assured would be in the remnant, if there should be any. A contract ought not to be

\textsuperscript{128} 789 F.2d 668 (9th Cir. 1986).
\textsuperscript{129} Id. at 671.
\textsuperscript{130} Id. at 672.
\textsuperscript{131} 700 P.2d 888 (Ariz. 1985).
\textsuperscript{132} Id. at 889.
\textsuperscript{133} Id.
\textsuperscript{134} Id. at 891.
\textsuperscript{135} 152 F. 961, 963 (6th Cir. 1907) quoted in Hertzka & Knowles v. Salter, 6 Cal. App. 3d 325, 335 (1970).
In rendering the opinion, the Grunewald Court said:

To permit Lloyds' interpretation of the provision in question would allow the possible depletion of all available coverage for damages to the insured's prejudice. We cannot envision such an arrangement as being within the contemplation of the assured under the policy. 137

Ambiguity may prevent the court from enforcing a DWL provision. In Branning v. CNA Insurance Companies, 138 CNA sought to have the court interpret its D & O liability policy as providing DWL. CNA's $3 million liability limit had been met or exceeded by $3 million in defense costs. The policy was somewhat similar in construction to the appraiser's Errors and Omissions policy in Grunewald. The “Limits of Liability” clause provided: “The insurer shall be liable to pay one hundred percent (100%) of any Loss (including costs, charges and expenses as referred to in Clause 5) in excess of the retention . . . .” 139 It also said the limit of liability “shall be the maximum aggregate liability of the Insurer with respect to claims made in each Policy Year.” 140

However, the policy defined “Loss” in terms of the amounts the directors and officers were obligated to pay, but added the language “and shall include but not be limited to damages, judgments, settlements, costs (exclusive of salaries of officers or employees), and defense of legal actions, claims or proceedings and appeals therefrom . . . .” 141 The issue was whether the policy provided for DWL or whether it was ambiguous.

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 a reasonable interpretation that the policy would pay $3 million in claims and defense costs on top of that. Consequently, it was sent back to the trial court for determination of the intent of the contracting parties.

The court noted that CNA had, on the same day, issued an IRA policy and a Keough policy to the Home Savings and Loan

137. Id. at 891.
139. Id. at 730.
140. Id.
141. Id. at 731.
Association which indicated in clear language on the first page that the limit of liability was inclusive of defense costs, and expressly so provided in the limit of liability clause. In comparing, the court concluded, with regard to the policy in issue "that a purchaser of insurance could reasonably review this policy and not be aware that the insurer sought to deduct defense costs from the limit of liability." Consequently, the court did not allow the reduction of the limit for defense costs.

On the other hand, a court will enforce an insurance policy that expressly provides for DWL. In Helfand v. National Union Fire Insurance Co., defrauded investors of Technical Equities Corporation, a securities brokerage, brought a declaratory action to determine the scope of coverage under D & O policies issued to the financially collapsed and bankrupt firm. One of the issues was whether the policy was a "wasting asset" so that the defense costs would be included in (deducted from) the $10 million annual indemnity limit.

The trial court ruled that defense costs were not included in the indemnity limit, reasoning that the policy was ambiguous "such that a normal insured would not be aware of its 'self-consuming' nature" and construing it as a DWL policy would defeat the reasonable expectations of the insureds as a matter of law.

The Court of Appeals disagreed, finding that the policy was not ambiguous and was "self-consuming" in nature. The court noted that the policy definition of "loss" included defense costs which 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 LIMIT OF LIABILITY." 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." On that basis, the court rejected the trial court's application of the reasonable expectations doctrine stating "the doctrine of reasonable expectation of coverage comes

142. Id. at 733.
144. Id. at 298.
145. Id. at 299.
146. Id. at 300.
147. Id.
into play only where there is an ambiguity in the policy.”

In Coleman Co. v. California Union Insurance Co., Cal Union was an excess insurer providing $1.5 million “following-form” coverage in excess of primary coverage of $1 million by Commercial Union and a retention by Coleman of $1.5 million. The primary coverage with Commercial Union unambiguously contained DWL provisions so that its limits could be exhausted by defense costs. Cal Union had agreed it would follow as excess behind primary insurance that was “standard CGL/Products form.”

The underlying DWL policy was sent to Cal Union which added an “Endorsement No. 10” providing that the excess coverage would follow the underlying coverage but that “an obligation to defend was not within the excess policy’s coverage.” Hence, there was no issue of whether the excess policy provided DWL. However, Cal Union promised to insure “in excess of the retained limit hereinafter stated which [Coleman] shall become legally obligated to pay as damages . . . .”

The issue, then, was whether the defense costs, which were included in the liability limit of the underlying policy, were “also included in calculating the attachment point of the umbrella policy.” Cal Union’s position was that defense costs could be used to exhaust the underlying DWL policy limit but could not be used to calculate the point of attachment at which the excess coverage would kick in. The court noted that Cal Union’s obligations were triggered when the “retained limit” was exceeded and that “retained limit” was defined only as the scheduled limit of the underlying insurance. Lacking any further definition, and swayed by the fact that the endorsement providing the excess coverage said it “shall follow and be subject to the same terms and conditions of the underlying policy,”

149. 960 F.2d 1529, 1531 (10th Cir. 1992).
150. A “following-form” policy provides coverage in the same form as the underlying or primary coverage.
151. Id., 960 F.2d at 1533.
152. Id. at 1531. A “standard form” CGL or comprehensive general liability policy refers to the forms put out by the I.S.O. and would not include DWL provisions.
153. Id.
154. Id. at 1533.
155. Id. at 1530.
156. Id. at 1536.
the court held that the excess carrier must look to the underlying policy which included defense costs in the limit of liability. Consequently, the court affirmed summary judgment on behalf of Coleman, finding Cal Union's coverage was triggered when the limits of the underlying policy were exhausted by defense costs.157

VII. STATUTORY LAW ON DEFENSE WITHIN LIMITS

Some states have enacted statutes regulating or prohibiting DWL provisions in insurance policies. Minnesota prohibits liability policies that reduce the limits of liability by the costs of legal defense.158 However, the statute exempts from its application, professional liability policies with liability limits greater than $100,000, environmental impairment insurance, insurance of large commercial risks (defined as those businesses with gross annual revenues of at least $10,000,000), and other coverages which the commissioner deems appropriate.159 The exemption of professional liability policies with liability limits of more than $100,000 makes the statute essentially moot for application to most professional liability policies and means that DWL is actually allowed for those policies in Minnesota.

New York permits insurers to offer defense within limits liability coverage for directors' and officers' liability coverage and for "Class 2 risks," those being "Large Commercial Insureds."160 The logic is that those insureds are sophisticated buyers who have the power to negotiate as they see fit and are often under manuscript policies in any event.

Montana prohibits any provision in a casualty insurance form "permitting defense costs within limits, except as

158. MINN. STAT. § 60A.08 (13) (1998).
159. Id.
161. N.Y. COMP. CODES R. & REGS. tit. 11, § 16.12 (1999) defines large commercial insureds as those (a) Policies providing liability coverage for directors and officers of corporations which: (1) have a net worth of at least $15,000,000, or (2) have gross assets exceeding $50,000,000 and a net worth of at least $3,000,000; or (3) is a for-profit business entity that generates annual gross revenues exceeding $50,000,000, and has a net worth of at least $3,000,000; or (4) is a for-profit business entity that has gross assets exceeding $50,000,000 and generates annual gross revenues exceeding $50,000,000; or (5) is a not-for-profit organization or public entity with an annual budget exceeding $50,000,000 for each of its three fiscal years immediately preceding the policy's effective date; or (b) Policies containing primary liability limits of at least $5,000,000.
permitted by the commissioner in his discretion."\textsuperscript{162} The statute provides no guidance to aid the commissioner's exercise of discretion.

Arkansas forbids defense within limits provisions in automobile liability insurance policies, but purports to allow defense within limits policy provisions in other liability policies, so long as the policy provides a separate limit for defense costs equal to the liability limit.\textsuperscript{163} In effect, this means Arkansas does not allow defense within limits in any policy, but does allow a limit on defense costs in liability policies other than auto. The statute appears to grant the commissioner discretion to allow DWL provisions if forbidding them is against the interest of public protection.\textsuperscript{164}

In Oregon, if the cost of defending the claim is included in the limits of liability, the policy may not be issued unless the form has been approved by the director of the regulating agency.\textsuperscript{165} The director considers the "circumstances and insurance needs of the proposed insureds."\textsuperscript{166} The statute requires the form include notice that the costs of defense are included in the policy limits.\textsuperscript{167} The statute applies to all liability insurance policies.\textsuperscript{168}

The Commissioner in Colorado may prohibit a claims-made policy that does not cover legal defense costs or includes them in the claims-made policy aggregate.\textsuperscript{169} In exercising that

\begin{itemize}
  \item \textsuperscript{162} MONT. CODE ANN. § 33-1-502(2) (1999).
  \item \textsuperscript{163} ARK. CODE ANN. § 23-79-307(5)(A) (Michie 1999).
  \item \textsuperscript{164} ARK. CODE ANN. § 23-79-307(5)(B). This subsection shall not apply to policies or contracts which the commissioner may exempt by order upon a finding that this subsection may not practically be applied or that its application is not necessary or desirable for the protection of the public.
  \item \textsuperscript{165} OR. REV. STAT. § 742.063(1) (1999) provides as follows:
    A liability insurance form that provides that the cost of defending a claim is included within the stated limits of liability may not be delivered or issued for delivery in this state until the form has been filed with and approved by the Director of the Department of Consumer and Business Services. In determining whether to approve or disapprove a form filed under this section, the director shall consider, in addition to the factors specified in ORS 742.005, the circumstances and insurance needs of the proposed insureds.
  \item \textsuperscript{166} Id.
  \item \textsuperscript{167} Id.
  \item \textsuperscript{168} Id.
  \item \textsuperscript{169} COLO. REV. STAT. ANN. § 10-4-419(3)(a) (West 1999) provides:
    The commissioner may prohibit the use of a claims-made liability policy if the policy does not contain one or more of the following policy provisions: (I) A policy provision that legal defense costs are covered by the policy but that legal defense costs are excluded from the claims-made policy aggregate . . . .
\end{itemize}
discretion under the statute, the commissioner must “recognize and balance the public interests in availability of insurance and adequate coverage at reasonable rates.” Colorado’s statute applies only to claims-made policies.

We can observe that 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.

On the other hand, Louisiana, which has no statute prohibiting DWL provisions, judicially recognizes a public policy against such provisions. Exceptions to that public policy occur in Louisiana in regulations of the Department of Insurance. One can conclude there is little statutory regulation of DWL and that the statutes have little effect. Indeed, one observer noted that when the industry offered only DWL policies in 1987, the commissioners all consented in their discretion under the statutes.

VIII. SOLUTIONS

There exist several approaches to dealing with the conflicts in the DWL policies. It is good to examine each for benefits and detriments. Consider the following:

A. Legislatively Forbid DWL Provisions in Policies

If DWL provisions were inherently bad as a matter of public policy or inherently anti-consumer, their legislative prohibition might make sense. However, such is not the case, and the consumer detriment can be remedied by other less drastic means that still allow DWL policies to add flexibility to the casualty insurance market. It appears that DWL policies have their place in high risk coverages such as large commercial insureds, professional liability, and environmental liability.

170. COLO. REV. STAT. ANN. § 10-4-419(3)(b).
173. Id. at 562-563.
Consequently, even in those states that purport to limit or prohibit DWL by statute, the high risk coverages are exempted or the commissioner is left with discretion to allow the provisions. This may reflect the necessity of DWL provisions in assuring enough predictability in higher risk insureds to make the insurance available. There is nothing inherently bad about DWL if the is fair and not the subject of misrepresentation.

B. Simply Allow a “Limits of Defense” Provision

The industry’s stated concern has been the unpredictability of costs of defense. It may be that the industry is simply unwilling to bear defense costs which rival the enormous limits of liability that enterprises now wish to purchase. At any rate, one solution to the unpredictability is to allow a “limits of defense” provision that parallels the standard “limits of liability” provision. The natural corollary would be to include the limit of defense on the declarations page of the policy where it would readily acquaint the insured with the information necessary to evaluate coverage and to compare coverage in relation to premiums.

The parallel limits of defense provision would leave the indemnity limit intact and avoid the ever present conflict involved when defense expenditures can exhaust the indemnity limit. However, if experience is any indicator, the insurers are likely to choose limits for defense expenditures far lower than their limits of liability. For example, the professional liability insurers who provide defense expenses outside the liability limit or as a threshold before being deducted from the liability limits have so far chosen to do so in amounts that are only a fraction of the limit. This brings up a different problem. Can the carrier withdraw from defense when its defense limit is exhausted, even though its indemnity limit is intact? Would the insured prefer the carrier continue defense under DWL at that point. Some carriers do that exactly.

Adopting a limits at defense provision is a straightforward option that makes clear the point at which risk of defense

175. But cf. Rosenberg, supra note 67, at 447. Rosenberg, an actuary for the New Jersey Department of Insurance asserts that actuarial rate making procedures have been developed over the past twenty years to make standard policies profitable without DWL.

176. See discussion infra part III.

177. See ABA chart for 2001, supra note 21.
expenses transfers to the insured. It removes the defense/settlement conflict and the issue of who should control defense. It is a good option that would be fair to the insurance consumer while meeting the need for predictability for the insurer.

C. Require Disclosure of DWL on Policy

Because of consumer familiarity with the standard policy and limit of liability provisions it is realistic to say that DWL provisions embedded in a policy with no disclosure may often be in derogation of the consumer's reasonable expectations. Oregon requires disclosure of DWL provisions and such disclosure in the policy or on the declarations page would correct the expectation that the policy is standard and would lessen the chance that the policy would be determined to be ambiguous by reason of its construction and layout. However, disclosure alone would do nothing to remedy the conflicts inherent in DWL or the disputes about control of the defense, notice of exhaustion and withdrawal of the insurer from the case.

D. Approve a DWL Provision Which Limits the Defense Costs that Apply to Reduce the Limit of Liability

There are several possible ways to do this of which I will mention two. First, cap the amount of defense costs that can be subtracted from the available indemnity limit, i.e., only those costs in excess of $25,000 or only the first $25,000 of costs. Second, set a minimum amount of the original liability limit which must remain available for payment of loss and from which defense costs may not be subtracted.

E. Make The DWL Policies Indemnity Policies Which Contain No Obligation to Defend on The Part of the Insurer

In essence, this is already done in the D & O policies. Costs of defense would be subtracted from the limit of liability, but the insured would defend and seek reimbursement. The insured would exercise much greater control over the allocation of the indemnity limit to settlement or defense expense freeing the

179. Rosenberg, supra note 67, at 462.
180. Id. at 449, n.8.
181. Id. at 462.
insurer from risk of conflict. However, this may leave insureds bearing at least an interim financial burden for defense until reimbursement. Also, insurance consumers excluding commercial insureds, will not want the responsibility of managing the defense. For example, issues of priority of payment of loss versus defense expense will also exist with this option.

Another option is to allow the insured complete control whenever any potential conflict arises between the insurer and the insured, i.e., anytime the claim plus predicted costs of defense exceed the policy limit. The problem with this option is the insured may make an unreasonable settlement because of risk aversion. Also, the option deprives the insurer of the right to select counsel and decide matters of settlement and defense in many situations where removing that right is uncalled for.182

IX. CONCLUSION

The use of DWL provisions in casualty policies resulted in a very significant change in coverage for insureds. While, under standard policies their premiums bought a limit of indemnity plus an unlimited promise to defend, their premiums now purchase policies whose limit of indemnity is reduced by any effort to defend. If DWL was adopted to contain the unpredictability of defense costs in the face of increasing complexity of litigation, one cannot help but think 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 which 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 which is limitless for defense and for indemnity. It may still be a fact, however, that the financial benefit to the insurers will outweigh the detriment of any potential bad faith or excess claims suits.

182. 1 Windt, supra note 75, § 4.20, at 220. Windt asserts that the insurer should be deprived of control only where the conflict allows the insurer to control the outcome of a coverage issue, since, otherwise, the insured can seek remedy by action for breach of contract.
In the present market, DWL provisions remain a feature of insurance policies in the high risk areas of professional malpractice, directors' and officers' liability, environmental liability and liability of large commercial enterprises. If they are necessary to making insurance affordable in those areas, regulators should require their disclosure, so consumers are fully informed and not mislead into believing that have purchased the full limit of liability for indemnity against loss. It is too late to make insureds aware of the huge risk which was transferred to their shoulders when the insurance industry included DWL provisions in policies while adopting claims-made coverage.

As this article goes to press, it appears the market for professional liability insurance is hardening, and reinsurers are demanding primary insurers adopt DWL across the board.\textsuperscript{183} If that assessment holds true, the issues raised here will appear and be litigated in the courts. Reducing indemnity limits by defense costs will not be without limits.

\textsuperscript{183} Minto, \textit{supra} note 174.