dri™
The Voice of the Defense Bar

The Voice

February 19, 2014 volume 13 issue 7

This Week's Feature

Navigating the Ethical Minefield of "Burning Limits" Insurance Policies

by Robert S. Nobel and Eric D. Suben, Traub Lieberman Straus & Shrewsberry LLP, Hawthorne, NY

They are known as "burning limits," "defense within limits" (DWL), "wasting," "spend-down," "self-consuming," "self-liquidating," or even "cannibalizing" insurance policies. Whatever the name, the costs of defending an insured against a suit are included within the limits of the policy, leaving less money available to pay a judgment or settlement. Such policies exist in stark contrast to more commonplace liability policies, under which defense costs are in addition to the limits of liability and not subject to those limits. While there has been much commentary on the ethical issues implicit in the "tripartite relationship" among the insurer, defense counsel, and the policyholder where defense costs are in addition to the limits of liability, much less attention has been paid to the ethical issues presented by defense under a burning limits policy, which are, if anything, even more poignant. This article is an attempt to redress that imbalance.

Burning limits policies are designed to fix with certainty the insurer's total exposure for both defense and indemnity with respect to a covered loss. Such policies were originally intended to provide insurers a greater degree of predictability regarding their overall exposure for certain categories of losses, including errors and omissions/professional liability, directors and officers, etc. The benefits for policyholders include lower premiums.

Although there are clear benefits to both parties of a DWL policy, there are drawbacks as well. Ironically, one drawback for insurers is heightened exposure to claims of bad faith and extra-contractual liability. Such exposure arises because, while defense costs are included in the limits of liability, other features of the contractual duty to defend remain the same. For instance, the insurer retains the contractual right to control the defense and to require the insured's cooperation in the defense. At the same time, the available limit of liability is reduced by every action the insurer authorizes defense counsel to take. Multiple courts have recognized the inherent conflict in this situation between the interests of the insurer and the interests of the policyholder. Where there is even a suggestion that the insurer may be putting its interests ahead of those of the insured, bad faith liability may arise. So, too, where the insurer's actions may increase the likelihood of an uninsured exposure for the insured.

The insurer is only one player in the "tripartite relationship." Defense counsel also has to navigate the minefield of potential

dritoday

Join the DRI Community

In The Voice

This Week's Feature
DRI News
And The Defense Wins
New Member Spotlight
Legislative Tracking
Did You Know...?
Quote of the Week
DRI CLE Calendar

DRI Publications

Product Liability Defenses: A State-by-State Compendium

Links

About DRI
Amicus Briefs
Blawgs
For The Defense Archives
Membership
Membership Directory
News
CLE Seminars and Events
Publications
The Alliance
DRI International

Print to PDF

Share this newsletter

conflicts and ethical considerations. Counsel defending a suit in which the client is insured under a cannibalizing policy is placed in the unenviable position of having to temper his or her decisions regarding how to mount the best possible defense with consideration for the fact that every move will reduce the insurance policy and thus increase the likelihood of an uninsured exposure. To say that defense counsel simply must do what is in the best interests of her client ignores the reality that every motion, deposition, letter, or phone call—all of which may be necessary to position the case for a favorable resolution—also reduces the funds available for an eventual settlement or judgment.

In addition to these considerations, consider the ethical obligations imposed on defense counsel under applicable law. Defense counsel owes duties of loyalty, confidentiality, and zealous representation to the policyholder. At the same time, defense counsel reports to the insurer, takes the insurer's directives, and usually must comply with the insurer's litigation management guidelines. Discharging all these obligations while minimizing uninsured exposure to the policyholder is a balancing act indeed.

Defense counsel's ethical obligations are on the firing line when the "burning limit" is exhausted by defense costs, or by payment of a settlement or judgment with respect to fewer than all outstanding claims against the insured. The policy usually provides that the insurer's duty to defend ends when the applicable limit of insurance is used up in the payment of loss and expense. But while the insurer may be able to stop paying, defense counsel may be ethically obligated to continue the defense, although there are no funds remaining in the policy from which to be paid. Some commentators suggest that defense counsel preemptively negotiate a fee arrangement with the policyholder in case of such eventuality. But doing so may also raise some ethical questions.

The rights of the injured claimant are also impacted by DWL policies, and plaintiff's counsel must be wary in such situations. A "scorched earth" litigation strategy may be counterproductive where the need for an active defense will reduce the limits available to pay a judgment or settlement in the client's favor. At the same time, zealous advocacy may be the best way to establish case value and the policyholder's liability. Although the case has not yet come down, eventually some plaintiff may plausibly make the claim that its counsel behaved unethically by forcing the policyholder to mount an aggressive defense, leaving no funds available for plaintiff to recover at the end of the day.

Although case law remains sparse with respect to these issues, some courts nationwide have suggested that they would not be reluctant to reform DWL policies to remove the "burning" feature. For instance, in *Gibson v. Northfield Insurance Co.*, 219 W. Va. 40, 631 S.E.2d 598 (2005), the court found that a "Public Entity All Lines Aggregate" insurance policy, which had a "defense within limits" provision, was contrary to a West Virginia statute that set a minimum amount of motor vehicle insurance to be maintained. Accordingly, the appellate court remanded the case to permit reformation to conform with the statutory requirements. On a "more general note," the court stated its belief that "the inclusion of a defense within limits provision in a governmental entity's insurance policy offends traditional notions of fairness," absent facts that such arises from a bargained-for exchange.

In *NIC Ins. Co. v. PJP Consulting, LLC*, 2010 U.S. Dist. LEXIS 113207 (E.D. Pa. Oct. 22, 2010), the insurer (NIC) sought a declaration that its obligation to indemnify any judgment in favor of underlying plaintiff was limited by the policy's $50,000 Assault and Battery sublimit, that such sublimit was eroded by defense costs,

and that once legal fees and expenses exhausted the applicable limits of liability, the insurer had no further duty to defend or indemnify the insured. Considering this case of first impression, the court observed that several state legislatures and insurance commissions have banned or limited the use of DWL provisions and questioned whether DWL provisions were consistent with or contrary to Pennsylvania public policy, particularly where the amount of potential coverage is so low that legal expenses would almost certainly exhaust the policy limits long before trial.

For courts concerned with preserving the sanctity of contract, a better solution is suggested by *Everest Indem. Ins. Co. v. Aventine-Tramonti Homeowners Ass'n*, 2012 U.S. Dist. Lexis 33850 (D. Nev. March 13, 2012). Everest undertook the defense of two insureds under its burning limits Owner Controlled Insurance Program Policy. After expending $150,000 in defense, and facing rival claims from its insureds under the Policy exceeding the $850,000 remaining under the Policy, Everest filed an interpleader action naming a number of defendants, several of which asserted counterclaims for breach of contract, breach of the covenant of good faith and fair dealing, and declaratory judgment. The parties disputed whether the interpleader obviated Everest's duty to defend. The court ruled in favor of Everest, explaining that "[j]ust as an insured must seek payment for indemnity from the interpled funds once properly interpled, under a burning limits policy, an insured must likewise seek reimbursement for its defense." Thus, the court stated, "interpleader would seem to extinguish the duty to defend, because the potential for indemnification ceases when the policy limits are interpled, after which an insured can no longer reach any assets of the insurer under the policy, but only the interpled funds."

Interpleader may not be available or achieve the same result in all jurisdictions, may not be possible when competing claimants are located in multiple jurisdictions, and may not solve all the ethical dilemmas. Until further guidance is provided by the courts, insurers and counsel on all sides of the dispute should tread carefully when defense is within the limits of liability.

Robert S. Nobel
Eric D. Suben
Traub Lieberman Straus & Shrewsberry LLP
Hawthorne, NY

Back...