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Avoiding Bad Faith Perils of Defense-within-Limits Policies

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Most liability insurance contracts treat defense expenses as outside the policy limit. Such is not the case in defense-within-limits (DWL) policies, though. Detractors call them wasting, cannibalizing or self-liquidating policies since defense fees can consume the policy limit. DWL policies appear prominently in D&O coverage, legal and medical malpractice policies and now in some commercial general liability policies.

Defense-within-limits policies are attractive to insurers and policyholders alike. For insurers, capping the company's responsibility for legal fees is appealing. Instead of funding unlimited defense fees, an insurer knows that on a $1 million policy, it will pay no more than $1 million in legal fees and settlement payments, max.

Such policies also give policyholders financial responsibility regarding legal cost management. Policyholders who might desire a gold-plated defense, lobbying insurers to hire off-panel counsel at $600/hour, may forego such demands when they realize that every dollar spent on lawyers is one less dollar available for settling claims.

Since the insurer's exposure to whopping legal fees is limited, the cost of liability coverage for DWL policies may be less than comparable policies with unlimited defense features. Price-sensitive insurance consumers may thus find this feature attractive, particularly if they have spotless claim histories and feel confident that they will remain loss-free.

Denying coverage to an additional insured or denying the AI separate counsel could, in either case, trigger bad faith claims. Granting coverage to an AI or providing it with separate counsel can invite bad faith claims from named insureds.

Defense-within-limits policies may also appeal to an unlikely and perhaps unwanted sector, namely plaintiff attorneys. Policyholder lawyers may advance bad faith theories against carriers that write defense costs-within-the-policy-limit. Plaintiffs may try to advance emerging theories on various grounds. Here are a quartet of bad faith claim landmines can detonate from defense-within-limits policies:

1 The carrier mismanaged defense costs.

An insured can claim that the carrier "fell asleep at the wheel" in managing legal fees which, in turn reduced the money available for paying claims.

2 The carrier's unwarranted decision to defend an additional insured (AI) accelerated depletion of the *named* insured's coverage.

Named insureds may balk at the insurer accepting coverage for additional insureds, even if the facts and policy language support that decision. (I've also had files where the named insured — for customer/business relation reasons — lobbied the carrier to accept AI status despite the policy and the facts not supporting it.)

Often in litigation, named insureds and additional insureds have clashing interests. Recognizing this danger and as a precaution, adjusters may hire separate counsel for the additional insured. Additional insureds may demand separate counsel to avoid conflicts of interest. Failure to split the file via separate counsel can expose the insurer to bad faith claims from additional insureds.

For adjusters, this is yet another no-win situation. Denying coverage to an additional insured or denying the AI separate counsel could, in either case, trigger bad faith claims. Granting coverage to an AI or providing it with separate counsel can invite bad faith claims from named insureds.

3 The insurer failed to adequately communicate with the policyholder about the policy's burn rate from accumulating legal expense.

Occasionally, defense expenses can rapidly erode policy limits. Or fees may be modest but defense counsel has an eye-popping litigation budget which will exhaust the insurance. If the carrier fails to regularly communicate the burn rate to the insured, the latter may claim he was kept in the dark and had he known of the case's policy erosion, he would have sought an earlier claim settlement.

4 The carrier failed to seek or pursue settlement opportunities before exhausting the policy limit.

This is a variation on "the insurer failed to settle when it could have and should have." Policyholders can allege that the carrier, knowing that defense costs depleted the limits, should have explored early settlement before substantial depletion of the policy limits, when more indemnity dollars were available. Delay in pursuing settlement led to a situation where by the time the carrier sought settlement, the amount left on the policy was insufficient to address the claim and forced the insureds to dip into their own funds.

Turning from dangers to remedies, here are five practical tips for avoiding these claims. Identifying the pitfalls virtually suggests the preventative step in each case:

1 Remind the insured what kind of coverage was purchased.

Provide a friendly refresher to the insureds that they bought eroding limits. The initial claim acknowledgment letter is a good time for this. Some policyholders may have forgotten this aspect of their coverage, rosily presuming that claims will never happen.

2 Carefully weigh additional insured claims.

Are they genuinely entitled to additional insured status? Decide based upon the merits of the AI's arguments, not on based on whether or not accepting the additional insured will further deplete policy limits. Also, alert the named insured that other entities are seeking AI status, the viability of those claims, and the ramifications of AI coverage on depleting the insurance limits.

3 Proactively manage legal fees.

Sound litigation management disciplines apply even more here. Negotiate competitive hourly rates. Review bills. Audit invoices. Question staffing or charges that seem excessive. Require periodic budgets from counsel. Exercise due diligence in cost management. Let the policyholder know you're minding the store and watching the meter.

4 Communicate with insureds about accumulating payments and limits erosion.

DWL policies may heighten the need to send excess *ad damnum* letters [which explain the amount that can be recovered under a default judgment] to policyholders and convey the latter's right to engage separate counsel. Err on the side of over-communicating. Build a record to let them know how much the carrier has spent and how much is left. Loss runs can serve this purpose, but better still are periodic letters or emails to the policyholder. Share copies of counsel's litigation budgets. Build a paper trail to show that the policyholder has been informed of accumulating expenses and policy limit erosion.

5 Seek and seize early settlement opportunities.

Evaluate claims early with regard to liability and damages in litigated cases. Seek early defense counsel assessments of the odds of prevailing and of the claim's compromise settlement value. An old adjusting maxim is, "Claims — unlike fine wine — do not improve with age." Typically, the longer a claim goes on, the more expensive it is.

The take-away: seek early windows of opportunity for settlement before there is a risk of policy depletion due to defense costs. Sound advice, not only in "eroding policies," but when dealing with defense-outside-of-limits policies.

No magic bullets will insulate adjusters from bad faith claims arising from eroding policies. Self-eroding policies do not erode the adjuster's good faith duties. If anything, they call for additional care in navigating potential traps and pitfalls. Use these practice tips, though, to minimize the risk of extracontractual liability claims arising from these coverages.

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