

# ANDERSON KILL POLICYHOLDER ADVISOR

The Policyholder Law Firm



## Frying Pan or Fire? Policyholders Beware the Strange Incentives in “Burning Limits” Liability Insurance Policies

By William G. Passannante

We buy liability insurance policies to protect against claims, and the average policyholder expects that their insurance company and the defense counsel they pay for are united in interest to protect the policyholder from loss. One way that this unity of interest has been promoted has been the traditional “defense outside of limits” insurance policy. Under such a traditional standard policy, the insurance company is required to pay defense costs *in addition to* the full policy limit of the liability policy, which remains 100% available for the payment of judgments or settlements. Thus, even though an extensive and perhaps lengthy defense effort may be needed, the limits available to pay a judgment are not reduced.

By stark contrast, enter the “burning limits” or “wasting” policy whose limits of liability are reduced with each payment of defense-related expense. Defense within limits or burning limits policies have appeared in directors and officers, errors and omissions, employment practices, and some general liability insurance

programs. Where they do appear, the nontraditional “wasting” nature of limits creates strange incentives and responsibilities.

For example, assume that an average E&O policy has limits of \$750,000, and that an E&O claim costs \$400,000 to adequately defend in order to posture the case for resolution favorable to the policyholder. Further, assume that your defense counsel tells you that a favorable resolution is a settlement in the amount of \$450,000. The settlement is well within the original limits of the policy. Including the expenditure of defense costs, however, the total loss now exceeds the limit of insurance by \$100,000. A burning limits policy leads to insufficient limits available to protect the policyholder in this example.

### Defense Outside of Limits Policies Provide More Protection

Policyholders are better protected when defense costs do not erode the limit of liability. Indeed, some courts and statutes have cast doubts on the propriety and public policy implications of burning limits liability insurance policies.

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For example, the New York Department of Insurance offers an opinion (Op. No. 08-10-07)\* regarding the defense obligation in D&O liability insurance policies, finding that a D&O policy that requires defense within limits violates insurance regulation. The opinion states:

Pursuant to 11 NYCRR § 71.2(a), a liability policy may not contain any provision that limits the availability of legal defense costs (except as otherwise provided for elsewhere in Part 71). That regulatory provision reads as follows:

(a) No liability insurance policy, except as specified in this Part, shall be issued or renewed in this State containing a provision that:

- (1) reduces the limits of liability stated in the policy by legal defense costs;
- (2) permits legal defense costs to be applied against the deductible, if any; or
- (3) otherwise limits the availability of coverage for legal defense costs.

Similarly, courts may find that a policy drafted to reduce limits by payment of defense costs violates such a statute. *Gibson v. Northfield Ins. Co.*, 219 W. Va. 40, 631 S.E.2d 598, 2005 W. Va. LEXIS 190 (W. Va. 2005) (citing W. Va. Code 33-6-31(a) to rule that a provision nullifying liability insurance mandated by statute is ineffective); *see also* Ark. Code Ann. §23-79-307(5)(A) (requiring an additional separate full limit for defense costs).

Insurance companies under more traditional insurance policies face a potentially significant exposure to defense expenses above the limits of the policy. They thus have a strong financial interest in resolving a matter and limiting their exposure to defense expenses. By contrast, the burning limits policy presents a lower and lower future exposure to expense based on the regular reduction of policy limits by payment of defense costs.

In *NIC Ins. Co. v. PJP Consulting, LLC*, 2010 U.S. Dist. LEXIS 113207, 2010 WL 4181767 (E.D. Pa. Oct. 22, 2010)(declining jurisdiction on abstention grounds), the insurance company argued that its obligation to indemnify the underlying plaintiff was limited by the insurance policy's \$50,000 limit, which had been eroded by

defense costs. The insurance company argued that since defense costs already had eroded the limit of liability that it had no further duty to defend or pay indemnity amounts on behalf of the policyholder. The court observed that defense within limits insurance provisions are controversial and might be contrary to Pennsylvania public policy, especially where the limit of liability in the policy is low.

Such a situation suggests that defense expense would easily exhaust policy limits prior to the conclusion of any defense. Statutes, courts and commentators that have reached such conclusions appear to do so to avoid the dilemma of the defense costs being expended to defend the insurance company's interests, leaving the policyholder without limits available to resolve a matter and more properly protect the policyholder.

### **Plaintiff's Counsel Need Be Aware of Burning Limits**

In many ordinary liability claims, the most significant asset available for a plaintiff's recovery is the proceeds of a liability insurance policy. The plaintiff's lawyer who engages in "scorched earth" litigation over an extended period of time may actually leave the client without a viable source of recovery. In this sense, burning limits insurance policies may in certain circumstances encourage plaintiffs and their counsel to resolve matters earlier than they might otherwise. In situations requiring a more extensive defense, however, such a straightforward solution under a burning limits insurance policy is not available.

### **Defense Counsel Represents the Client as a Whole**

Similarly, defense counsel faces an additional concern when defending clients under a burning limits insurance policy. Such a limitation on the expenditure of defense costs puts a premium on ensuring that defense counsel represents the interests of the policyholder. For example, early budgeting and early case assessment is at a premium in a situation where every dollar of defense expense reduces available limits for the payment of a judgment or a settlement. Furthermore, defense counsel should exercise care in responding to inquiries regarding the amount of available liability insurance. Since

limits are further depleted with the passage of each month, such information should be considered carefully when responding to inquiries regarding available limits of insurance.

Furthermore, a burning limits insurance policy presents at least the possibility that defense counsel, engaged to represent a policyholder, might be required to continue a defense after the exhaustion of liability insurance limits. In most states, when an attorney seeks to terminate the representation of a client in litigation, that attorney may only do so after taking reasonable steps to avoid foreseeable prejudice to the client. Further, an attorney, after having appeared for a client in court, may only withdraw from such representation in compliance with the applicable rules of such court. These ethical obligations apply regardless of who was paying for defense counsel's services prior to such termination. New York Rules of Professional Conduct Rule 1.16: "Declining or Terminating Representation"; *Matter of Kuzmin*, 98 A.D.3d 266, 949 N.Y.S.2d 47,

2012 N.Y. App. Div. LEXIS 5631, 2012 NY Slip Op 5708, 2012 WL 3000462 (N.Y. App. Div. 1st Dep't 2012) (lawyer repeatedly failed to formally withdraw from cases as required).

### Lower the Heat!

Burning limits insurance policies often provide less protection to policyholders. Even insurance regulators and courts have recognized that the more traditional non-wasting, non-burning limits policies usually provide better protection, and that deviation from such coverage may offend insurance regulations or public policy. Plaintiff's counsel need to be aware of their role in reducing the potential limits available to pay a judgment, and defense counsel must be aware of how burning limits liability insurance policy may impact their ability to protect their client. Armed with an understanding of these dynamics, a policyholder can navigate the strange incentives in burning limits insurance policies. ▲

\*<http://www.dfs.ny.gov/insurance/ogco2008/rg081007.htm>

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## About Anderson Kill

Anderson Kill practices law in the areas of Insurance Recovery, Commercial Litigation, Environmental Law, Estates, Trusts and Tax Services, Corporate and Securities, Antitrust, Banking and Lending, Bankruptcy and Restructuring, Real Estate and Construction, Foreign Investment Recovery, Public Law, Government Affairs, Employment and Labor Law, Captive Insurance, Intellectual Property, Corporate Tax, Hospitality, and Health Reform. Recognized nationwide by Chambers USA for Client Service and Commercial Awareness, and best-known for its work in insurance recovery, the firm represents policyholders only in insurance coverage disputes — with no ties to insurance companies and has no conflicts of interest. Clients include Fortune 1000 companies, small and medium-sized businesses, governmental entities, and nonprofits as well as personal estates. Based in New York City, the firm also has offices in Philadelphia, PA, Stamford, CT, Washington, DC, and Newark, NJ.

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