# The Perils of Eroding Liability Policies: How to Avoid Getting Burned

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## Introduction

Over the years, there has been an upward trend in the offering of defense-within-limits professional liability insurance policies by carriers which commonly provide a more affordable cost of premium. It is attractive to the insurance carrier as it places a ceiling on the amount of defense costs and liability exposure. The affordability makes it attractive to the insured. Yet, the insured may not always understand or foresee the potential ramifications of such policy.

Under this type of policy, every dollar spent in defending the suit results in a reduction of dollars available on the policy to resolve the suit by settlement. There is pressure on defense counsel to refrain from conducting certain work-up of the file, yet, if the plan is to proceed to trial, the risk of foregoing necessary strategies may result in a less than favorable outcome. Conversely, one may run the risk of depleting the policy with an aggressive defense which can be devastating to the insured if there is a plaintiff's verdict. Moreover, is the greater concern that we, as defense counsel, may be compromising the defense of our clients by curtailing necessary investigation and discovery due to the depleting policy.

This following shall address the risks and consequences of defending an insured with an eroding policy, including exposure of the broker for proposing such policies to high-risk professionals to bad faith or legal malpractice actions. We will address consequences of policy limits demands and provide best practices for navigating through defending an insured with an eroding policy.

## Defining Eroding Policies

Eroding, burning, wasting, defense-within-limits, self-reducing and cannibalizing, are all interchangeable terms used as descriptions of insurance policies that are written with terms that include limits of liability for settlement or judgment to be reduced by the amount of legal costs and expenses incurred during the course of the defense. This is in stark contrast to a non-eroding policy in which case the limits of liability are reserved for payment of damages by way of settlement or payment of a judgment. In the eroding policy, the more you spend, the less there is available to the insured to use as settlement funds, or otherwise to pay for the cost of defense through trial, or the worse case scenario, a judgment if there is a plaintiff 's verdict and there is little or no funds left of the policy. This can result in the worst case scenario of the insured being left not only with a judgment, but also attorneys' fees, expert witness fees, and a multitude of vendor bills. On the other hand, the defense counsel can also be left short-handed if the insured has no monies left on the policy to pay for defense fees and costs.

Another pitfall of the eroding policy is that high risk professions, such as surgeons and obstetricians, who may benefit from a lower cost of insurance, may be not cognizant of the real possibility that in one lawsuit, the costs of defense may leave them with little policy funds with which to settle the case and worse yet, result in a potential verdict and exposure that will impact the insured's personal assets. Eroding policies also have the potential to result in bad faith litigation with allegations that the insurance carrier failed to adequately monitor and control defense costs and/or failure to make efforts to settle the claim within the remaining policy limits before it is exhausted.

The Case Against Eroding Policies

There are a growing number of states enacting legislation to prohibit the issuance of eroding policies. Nevada recently joined the minority of states which are now prohibiting these types of insurance policies. The new Assembly Bill 398 states in pertinent part, that insurers shall not renew or issue a liability policy that reduces the policy limit "by the costs of defense, legal costs and fees and other expenses…" or otherwise "limits the availability of coverage for the costs of defense, legal costs and fees and other expenses…." Other states that have either prohibited or otherwise regulated these types of policies include, Arkansas, Oregon, Minnesota, Montana and New York. The premise is that while the policy is eroding during each step of the litigation, it should not erode the insurer's fiduciary duty to provide the best defense to protect the interests of its insured. The key consideration is whether eroding policies violate public policy

Of course, the vast majority of the states currently allow such policies. There are a few of those states whose courts have not upheld eroding polices based upon various grounds including ambiguity of terms. In the case of *Illinois Union Ins. Co. v. N. Co. Ob-Gyn Medical GR* (2010) 09cv2123-LAB (JMA), the United States District Court, S.D. California, affirmed an arbitration ruling that the terms as written and defined in an eroding policy were ambiguous to the extent that the inured reasonably lacked an understanding that such policy would erode with cost of defense.

The issue arose between the insurance company and a medical group. The terms at issue involved a question as to whether the payment of defense costs to the medical group's attorneys for its defense constituted a 'loss" pursuant to the policy. The other terms at issue were the definition of "Costs, Charges, and Expenses." When the policy limits had completely eroded prior to trial, the defense counsel continued to represent the insured to the end of resolution. The medical group took the position that the insurance company had a duty to defend separate and apart from the duty to insure and that its defense costs should be paid from the point of full erosion of policy limits until the resolution of the case.

In essense, the Court affirmed the arbitration tribunal's decision that the language of the policy was ambiguous enough to require the insurance company to reimburse the insured for its costs of defense that was incurred once the policy limits were fully eroded. The court reasoned that the ultimate decision maker was the use of the phrase " incurred by insureds" in the policy.

The policy stated in part: "[l]oss means the damages, judgments, settlement…awarded by a court, and Costs, Charges and Expenses incurred by any of the insureds."(Policy 28) "Costs, Charges and Expenses means reasonable and necessary legal costs, charges, fees and expenses incurred by any of the insureds in defending claims." (Policy, 9) Id.

The court focused on the above words and found that the medical group did not "incur" any costs in the form of legal fees, as such fees were being paid by the insurance company until the exhaustion of the policy limit. Thereafter, the insured's lawyers were incurring the cost of

defense. Ultimately, the court found in favor of the insured due to the fact that the costs were incurred by the attorneys rather than the medical group once the policy had fully eroded. Of interest, the court concluded that there was a lack of communication between the parties as to clarity which was needed once the limits had eroded with respect to moving forward with the defense.

Other examples of successful challenges to an eroding policy involve the insurer's failure to declare a reservation of rights, *Lexington Ins. Co. v. Swanson* (Wash.2007) 240 F.R.D. 662; and defense counsel's failure to identify the eroding nature of the insurance policy in discovery responses, *Nat'l Fire and Marine Ins. Co v Lindemann* (S.D. Ill.2018) No 3:2015cv00910.

The Tripartite Relationship

The tripartite relationship is made up of the insurer, the insured, and the defense counsel retained by the insurer to defend the claim. This concept is designed to facilitate a coalition between the three parties to work together in effort to reach a mutually favorable outcome. However, there are many instances when ethical dilemmas arise, leading to the need to conduct checks and balances in order to ensure that best interests of client and carrier are met. It is said that the defense counsel has two clients. Yet, the two clients may have differing opinions as to strategy, settlement value, and liability exposure. Consent-to-settle and hammer clause policies pose additional considerations. In the first circumstance, if the insured refuses to consent to settle when the prospect of depletion of the limits of policy pose great concern, much counseling is needed to ensure the insured understands the risks and consequences of the eroding policy. Conversely, in a hammer clause policy, the insurer may assert this right and cause resolution of the claim against the wishes of the insured, due to policy limitations concerns. In either situation, defense counsel is left in the middle of the controversy.

Another challenge of the tripartite relationship arises when policy demands are made. Defense counsel has no choice but to counsel the insured and advise that a demand to settle within policy limits letter must be sent to the insurer to protect the insured's personal assets. Plaintiffs' counsel often make policy demands for the sole purpose of compelling the defense counsel to make such recommendation Plaintiffs' counsel then argue that if the policy demand is not accepted, it has become a "lids off" policy, whereby arguably the insurer will be responsible for payment of a verdict in excess of the policy limits. Certainly, insurers would rather defense counsel refrain from providing such recommendation to the insured yet, defense counsel will potentially face exposure for failing to make such recommendation to the client, if the claim results in a verdict in excess of remaining policy limits.

In a typical insurance policy, the insurer enters into a contract with the insured that includes the provision by the insurer of competent defense counsel. In such case, the insurer has a duty to defend and indemnify the insured for certain risks and losses. Yet, the insurer is paying the fees and costs incurred for defending the claim and may or may not continue to retain such counsel depending upon the outcome and track record of the assigned counsel. Defense counsel are expected to be cost conscious on behalf of the insurer and yet, still represent the best interests of the insured by providing a comprehensive work up and prepared defense. This can lead to many ethical dilemmas. This is further compromised in the event of an eroding policy, as defense

counsel can be limited in the number and quality of the experts, the amount of depositions and discovery conducted, as well as the use of additional adjunct specialists such as technical experts and jury consultants for mock trials and witness preparation. This can be most challenging when faced with a complex case with catastrophic injuries. In most eroding policies, when the policy runs out, defense counsel may find themselves without compensation and the insured may be without indemnification.

Early Evaluation of Exposure and Budgeting

It is not surprising that in all claims, the insurer wishes for its defense counsel to conduct an early evaluation and determine liability and exposure shortly thereafter. In the case of the eroding policy, the initial measures are undoubtedly necessary. With such policies, it will be important to determine exposure and the anticipated cost to take the matter to trial if it appears to be a fully defensible matter. Even in the strongest case, if it is a high exposure matter that will require numerous experts and a lengthy trial, one must assess whether the anticipated budget to take the matter to trial will exhaust the policy. Careful consideration must be employed to determine whether the risk of being left without indemnity may result in the need to resolve the case rather than proceeding to defend it. Frequent and measured budgeting must be prepared with routine assessment of the fees and costs incurred . Additionally, when responding to discovery, early advisement of the eroding policy is recommended. In such case, this may lead to speedy resolution as plaintiffs' counsel may wish to settle prior to substantial erosion of the policy.

Policy Offers

When responding to policy demands whether statutory or otherwise, defense counsel must immediately provide detailed notification of the demand and ensure of its receipt by the insured and insurer. Enclosing a copy of the demand is wise with specificity as to the terms and the deadline to be included. If the insurer and /or insured are not in a position to settle for the policy at that time, a thoughtful and thorough meet and confer letter or formal objection, should include detailed reasoning for the lack of ability to accept the demand or statutory offer. Recitation of supporting case law for the various elements of the inability to respond within the prescribed deadline is also recommended. If the eroding policy has not yet been disclosed, now will be the time to set forth that the amount of the demand or statutory offer exceeds the current limits of the policy due to its defense-within-limits nature.

Concluding Remarks

In summation, defense counsel's appreciation of the pros and cons of eroding insurance policies and the tripartite relationship will be key in defending a claim with this type of policy.
The development of strategies to navigate through litigation with early evaluation of exposure and budgeting will be helpful in containing costs of defense. Identifying best practices for responding to policy demands and communication with the client and carrier will also prove to be beneficial. As the court alluded to in the aforementioned California District Court Case, Illinois Union Ins. Co., communication and clarity are key factors in defending our clients in not only claims with eroding policies but in all circumstances.