Insurer Considerations and Strategies Where Defense Is Within Limits

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INTRODUCTION

Where claim expenses erode limits available to settle claim, the table stakes can quickly change. Claim investigation and resolution efforts may become highly time-sensitive. An insured who wants a no-holds-barred defense under a policy that provides for defense costs in addition to the limit of liability might be defense budget sensitive when the defense costs erode limits. Frequently made arguments that the coverage action must be stayed pending resolution of the underlying action simply fall by the wayside. And multiple insureds may all scramble to take advantage of a depleting limit first before it is gone. Some of the key considerations for insurer in this scenario include:
Choice of Law

The insurer’s rights and obligations vary from jurisdiction to jurisdiction. Depending on the choice of law, an insurer may or may not have a duty to initiate settlement discussions, may be required or precluded from paying a claim that exhausts settlement limits if other claims remain pending, and will have varying obligations with respect to whether and when independent counsel is required. Too often, parties assume that the law of the jurisdiction where the named insured is located will apply, but that is not necessarily correct.

For example, suppose a lawyer’s professional liability policy is issued through a Florida broker to a law firm with its main office in Florida. The firm has two additional offices in New York and New Jersey. A client of one of the firm’s lawyers in New York files a suit in New York against that lawyer and the firm for legal malpractice and fraud in connection with a business deal between the lawyer and the client. Can the insured, with its principal office in Florida, effectively use a Florida civil remedy notice to complain of failure to settle the claim within limits and trigger the implications of that notice? Can the insurer rely on New York case law regarding reimbursement of defense costs if the insurer takes the position that coverage for the claim is barred but it nonetheless will advance defense costs pending a judicial determination of coverage?

The fact that the Named Insured law firm is a Florida entity does not, by itself, answer the choice of law question for the purposes of the insurance coverage considerations. The choice of law determination requires the identification of the potential fora for any coverage dispute based on personal and subject matter jurisdiction, an application of the choice of law rules in that jurisdiction (i.e., the most significant contacts test, lex loci contractus, etc.), an analysis of the relevant facts for the choice of law test in the potential fora, and consideration of the substantive insurance law in one or more jurisdictions whose law could apply. This determination should be undertaken at the outset of each matter. Once the potentially applicable law is identified, then the insurer can determine how its rights and responsibilities under the policy might be construed.

Because choice of law issues can be thorny and outcome-determinative, some have advocated for broader use of choice of law provisions in policies. Indeed, certain insurers include choice of law provisions in various eroding limits policies, such as directors and officers liability policies. During a recent oral argument in a coverage appeal where millions of dollars turned on the issue of whether Michigan or Indiana law applied, Seventh Circuit Judge Richard Posner pointedly suggested to the parties that the entire dispute could have been prevented by including a choice of law provision in the policy. According to Judge Posner, “I don’t understand why you think that somehow, that would be more complicated than forcing courts to go through this struggling mush of choice-of-law principles.” Not all judges share Judge Posner’s view, however, and some courts have found reasons to refuse to enforce policy choice of law or forum selection provisions. See, e.g., Param Petroleum Corp. v. Commerce & Indus. Ins. Co., 686 A.2d 377 (N.J. App. Div. 1997) (“At least when dealing with risks located wholly within this state, we are of the view that the parties to the insurance contact should not be permitted to negotiate away the protection of our courts, protection which is intended for the insured, the insurance company, and for those who may suffer damages as a result of an insured risk.”). The bottom line is: do not overlook the choice of law analysis at the outset and do not assume that the law of the jurisdiction where the Named Insured is located will control.

Duty to Settle

Depending on the applicable law, the insurer may have an affirmative duty to initiate settlement efforts, even in the absence of any settlement demand or a demand within limits. The insurer should give careful consideration at the outset of the claim, and throughout the life of the matter, whether under the applicable law it should affirmatively seek settlement where liability is clear and injuries are serious enough to suggest that any judgment is likely to exceed limits. An
eroding limits policy will bring these issues to the fore more quickly than a policy with defense outside limits.

Oregon, for example, imposes such a duty by common law in some circumstances. “The duty to defend includes the duty to settle the case within the policy limits if it would be reasonable to do so.” Goddard ex rel. Estate of Goddard v. Farmers Ins. Co., 22 P.3d 1224, 1227 (Or. Ct. App. 2001). Oregon law also indicates that an insurer may be required affirmatively initiate settlement negotiations. See Me. Bonding & Cas. Co. v. Centennial Ins. Co., 693 P.2d 1296, 1299 (Or. 1985) (“Due care may require that an insurer make inquiries to determine if settlement is possible within the policy limits.”). West Virginia has a “[h]ybrid negligence-strict liability” standard that requires the insurer to settle claims where there is “opportunity” to settle within limits. Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990). The insurer has the burden to rebut a prima facie claim of bad faith failure to settle and must show by clear and convincing evidence it “act[ed] in good faith in actively seeking settlement and a release of its insured from personal liability.” Id. at 776–77. Other jurisdictions, including Massachusetts and Washington State, impose a duty on insurers to affirmatively seek settlement where liability is reasonably clear. Under Massachusetts law, an insurer should “promptly . . . put a fair and reasonable offer on the table when liability and damages become clear, either within the thirty-day period set forth in G.L. c. 93A, § 9(3), or as soon thereafter as liability and damages make themselves apparent.” Hopkins v. Liberty Mut. Ins. Co., 750 N.E.2d 943, 951 (Mass. 2001) (citing G.L. 176D § 3(9) and G.L. c. 93A, § 9(3)). Washington law similarly prohibits insurers from “[n]ot attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.” WAC 284-30-330(6).

The majority of courts agree that an insurer is free to litigate or settle a claim without facing potential extracontractual exposure so long as the insured has a real chance of a verdict in its favor or a judgment in the remaining policy limit and the insurer makes and honest assessment of the chances of a successful defense. See, e.g., Johnson v. Am. Fam. Mutl. Ins. Co., 674 N.W.2d 88, 90-91 (Iowa 2004); but see Pueblo Country Club v. AXA Corp. Solutions Ins. Co., 2007 WL 951790 (D. Colo. Mar. 28, 2007) (denying insurer summary judgment for bad faith claim where insured argued that eroding policy limit potentially exposed insured to judgment in excess of remaining limit). Nonetheless, while the limits are eroding, the evaluation of that success is a constantly changing calculation that should be carefully monitored.

**Resolving Claims With Depleting Limits**

The majority of jurisdictions allow the insurer to settle claims against fewer than all insureds, even if doing so would exhaust policy limits. For example, in Millers Mutual Insurance Association of Illinois v. Shell Oil Co., 959 S.W.2d 864 (Mo. Ct. App. 1997), the court explained that:

> In insurer should not be precluded from accepting a reasonable settlement offer for fewer than all insureds. By accepting the offer the insurer would avoid being subjected to liability exceeding the policy limits due to its rejection of a reasonable offer. Further, any settlement would benefit all insureds by decreasing the total amount of liability in the underlying suit.

Id. at 870 (internal citations omitted); see also Anglo-Am. Ins. Co. v. Molin, 670 A.2d 194, 199 (Pa. Commw. Ct. 1995) (“[G]iven the dilemma faced by an insurer when faced with a reasonable settlement offer for less than all of the insureds, we conclude that the insurer should not be precluded from accepting that offer. By accepting an offer, the insurer will avoid being subjected to a liability exceeding the policy limits due to its rejection of a reasonable offer, and the settlement, as in this case, will benefit all of the insureds.”); Voccio v. Reliance Ins. Cos., 703 F.2d 1, 3 (1st Cir. 1983) (“[J]udicial decisions have consistently allowed insurers to settle on the basis of ‘first come, first served’”). Where the policy limits are being eroded by defense costs,
the insureds may jockey to use the limits first, before the other insureds deplete them. Indeed, they may seek judicial intervention to prevent the insurer from paying on behalf of other insureds or argue after the fact that the payments were not made in good faith.

However, there is a minority view in some jurisdictions that an insurer may not fully exhaust the proceeds of its policy in favor of a settlement of only one of its insureds and not all insureds. For example, in *Lehto v. Allstate Insurance Co.*, 31 Cal. App. 4th 60, 72, 75 (1994), a California intermediate appellate court stated that

> [an insurer owes the duty of good faith and fair dealing to each of its insureds, and cannot favor the interests of one insured over the other. Moreover, an insurer can breach its duty to its insureds by disbursing the policy proceeds to the insureds’ claimant without first obtaining a release of the insureds . . . . For the insurer to accept settlement offer here] would have left one of its insureds bereft of coverage, an act of bad faith.


> [It is absolutely no answer for the company to say that it paid the full amount of its policy if in so doing it fully protected one of its insureds and left the other completely exposed. While it is easy to see why [the insurer] acted as it did—the insured it protected was a policyholder, the one whose rights it ignored was an insured it was by law required to defend—there is no legal justification for its preferring one over the other.

The insurer has a duty to act in good faith, which may mean giving equal consideration to its own interests and the interests of the insured in deciding whether to settle. see *O’Neill v. Gallant Ins. Co.*, 769 N.E.2d 100, 106 (Ill. App. Ct. 2002), and may mean treating the exposure as if it were the insurer’s alone, see *Eastham v. Or. Auto. Ins. Co.*, 540 P.2d 364, 367 (Or. 1975). Evaluating the reasonableness of a potential settlement is highly fact-sensitive. Particularly where an insurer must attempt to settle all claims against an insured, the erosion of limits by defense costs complicates things. Information may be unevenly developed among the claims, making it difficult to fairly evaluate the relative reasonable claim value for all of the matters. Even in a “first in line” jurisdiction, the insured and defense counsel may be loath to develop the defenses for fear of eroding the amount available for settlement.

Adequacy of limits can be a tricky determination. In some jurisdictions, the insurer can take coverage issues into consideration in evaluating the reasonableness of a settlement demand, in which case the limits may be adequate for the covered claims, even if not adequate for all of the covered and non-covered claims. E.g., *Stevenson v. State Farm Fire & Cas. Co.*, 628 N.E.2d 810, 813 (Ill. App. Ct. 1993) (“Where a carrier can reasonably examine a set of facts and determine that the incident or occurrence which is the substance of the underlying controversy is not one contemplated by the policy, then it does not owe the same kind of duty [to give equal consideration to insured’s interests].”). In other jurisdictions, an insurer cannot take the coverage issues into consideration, and must evaluate the reasonableness of a settlement demand based solely on the merits of the underlying action. E.g., *Johansen v. Cal. State Auto. Ass’n Inter-Ins. Bur.*, 538 P.2d 744, 748–49 (Cal. 1975) (“Such factors as the limits imposed by the policy, a desire to reduce the amount of future settlements, or a belief that the policy does not provide coverage, should not affect a decision as to whether the settlement offer in question is a reasonable one.”).

In cases with serious coverage issues, where the settlement demand exceeds the fair settlement value without regard to coverage, insurers should carefully explain the basis for their response to a settlement demand, including how the reasonableness has been evaluated. Thus, an insurer
might specify that a demand is not reasonable and would not be accepted even if there were no coverage issues, and then, if appropriate, explain that as a separate and independent ground, one or more coverage issues affect the evaluation of the reasonableness of the demand.

Where the insurer determines that the reasonable settlement value exceeds the available policy limit, the insurer can offer to make the full remaining limit available to insured in the settlement process so that the insured can state any preference for how to spend the remaining amount. An insured would be hard-pressed to second guess the settlement decisions where the insured is in the driver’s seat. This does not to say that the insurer simply tenders its limit, but rather works collaboratively with the insured to determine the insured’s best interest to maximize the insured’s protection with the remaining insurance limit. Nor is the insurer necessarily bound by the insured’s views, but if the insurer believes that a settlement approach other than that preferred by the insured in these circumstances would be prudent, the insurer should explain to the insured and document those reasons.

So What's An Insurer To Do?

The insurer has many options, the availability of which will depend on the particular facts and circumstances:

- Early mediation before the matter proceeds to litigation or before litigation gets very far. The insurer will want to be sure that it has all available information about the claim and any other claims or potential claims under the policy. If multiple claims exist, consider a global mediation.

- Negotiated exchange of information. Sometimes the claimant will voluntarily exchange information without formal discovery and even provide early expert disclosures to allow the insurer to evaluate the claim to help avoid eroding the limit that the claimant is looking for in settlement.

- Stay the underlying action and proceed directly to the coverage action. If the coverage issues preclude recovery for the claimant and possibly would require the insured to reimburse defense costs, consider an immediate judicial resolution of the coverage issue. If the matter requires a judicial determination of a coverage issue, the parties might agree to waive initial disclosures, mutually exchange minimum information (if any is needed) and then seek dispositive motions.

- Is interpleader an option? If the limit is going to be used regardless, consider whether the court will help resolve the competing claims. While courts generally disfavor interpleader where defense is outside limits if it appears to be intended to limit a defense prematurely, the eroding limits policy presents a different rationale for interpleader.

- Policy buy back. If there are coverage issues, will the parties agree to a settlement that includes a buy-back and shifts risks of future claims?

- Policy limits reduction. Consider whether the matter can be settled so that the claimant is satisfied, the insured still has some amount of coverage, but the insurer’s risk is reduced by a negotiated agreed reduction through reformation or otherwise of the remaining available limits.

- If the insured is in bankruptcy or receivership, seek a bar order to help protect against any additional claims.
The use of any of these options, of course, requires careful consideration of applicable law in the relevant jurisdiction. However, eroding limits militates in favor of early creative thinking about how to maximize the available limits before they are gone.

**Don’t Be Caught Off-Guard by Insufficiency of Limits**

Insurers often cannot determine at the outset of a matter whether the limits are adequate. Sometimes, the claim information simply has not yet developed and sometimes, information is intentionally withheld as part of a “bad faith set-up.” Some insureds may make a demand that the insurer settle the demand by paying the full policy limit, but fail to provide information that would allow the insurer to reasonably evaluate the claim, including the potential for exposure in excess of available policy limits. In this way, the insured may be hoping that the insurer will fail to settle within limits and that it can pursue a bad faith claim. While the insurer has a good defense that the policyholder has breached the duty to cooperate, some courts will require the insurer to prove prejudice. See, e.g., *Belz v. Clarendon Am. Ins. Co.*, 158 Cal. App. 4th 615, 632 (2007) (insured’s “interference with [the insurer’s] ability to conduct a thorough investigation and to present a defense in the underlying suit . . . assumes ‘too lenient [a] test’ for prejudice”); *Billington v. Interins. Exch.*, 456 P.2d 982, 987 (Cal. 1969) (“[A]n insurer, in order to establish it was prejudiced by the failure of the insured to cooperate in his defense, must establish at the very least that if the cooperation clause had not been breached there was a substantial likelihood the trier of fact would have found in the insured’s favor.”).

The insurer should document its efforts to obtain the policyholder’s cooperation. See *B.R. Fries & Assoc.s, LLC v. Illinois Union Ins. Co.*, 934 N.Y.S.2d 10, 12 (App. Div. 2011) (finding that the insured did not breach its duty of cooperation, in part, because insurer “failed to show that it made efforts to respond to the additional insureds’ expressed hesitations or concerns” about providing certain files). The insurer also would be wise to carefully document both the conduct of the claimant and of the claimant’s attorney, which may be relevant to any subsequent dispute in the event that the matter is not fully resolved within the policy limits.

Insurers should be alert for changes in exposure throughout the life of the matter, which affect not only the claim value, but how the claim should be handled. For example, the Seventh Circuit, applying Illinois law, has concluded that the “nontrivial probability” of an excess judgment against the insured implicates an independent counsel obligation. *R.C. Wegman Constr. Co. v. Admiral Ins. Co.*, 629 F.3d 724, 729 (7th Cir. 2011). In *Wegman Construction*, the policyholder was sued after an accident at a construction site. It tendered its defense to its liability insurer, which then defended under a reservation of rights. During the course of discovery, deposition testimony indicated that the damages could exceed the policy limit, and at trial the claimant obtained a judgment that exceeded the limit. The policyholder argued that the insurer was on the hook for the entire judgment because, had the insurer informed the policyholder about the potential uninsured exposure, it would have rejected the defense, retained independent counsel, and settled the matter within the limit. The Seventh Circuit held that the new information developed in discovery gave rise to a conflict of interest between the insurer and insured, requiring the insurer to notify the insured and give the insured the opportunity to proceed with different, independent counsel. Having not taken that approach, the insurer was liable for the entire judgment, including the amounts in excess of the policy limit.

The lesson of the *Wegman Construction* case is that whether the policy limits might be inadequate - as a result of claim expense or otherwise - can change during the life of the matter, and when changes arise, the insurer should be mindful of whether applicable law requires a new approach in the handling of the claim.