Challenges to Policies with Defense Within Limits Provisions

By

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I. Introduction

One court described defense within limits (hereinafter "DWL") policies as including:

> [A]ll defense costs and litigation expenses within the applicable limits of liability. Under such policies, the insureds' costs of defense, including attorneys' fees, expert witness fees, and other litigation expenses, are paid by the insurance companies and deducted from the policy limits as they are incurred, thereby reducing the amount of insurance coverage available to pay settlements or satisfy judgments. In short, every dollar spent on defense reduces the amount available to satisfy potential judgments.[1]

The purpose of DWL policies to add more certainty to the underwriting process for classes of business that tend to generate high costs of investigation and defense. Whatever the underwriting benefit, DWL policies have proved controversial leading to some negative reactions by courts, regulators and legislatures. The purpose of this article is to explore selected case law on point plus some of the public policy issues that have influence the courts as well as regulators and legislators.

II. Case Law Supporting DWL Provisions

A recent case provides a good example of this group of decisions: *Fed. Ins. Co. v. Singing River Health Sys.,* 850 F.3d 187 (5th Cir. 2017). The policy in question stated that limits "will be reduced, and may be exhausted by defense costs . . ." with such costs being defined as "reasonable costs, charges, fees (including but not limited to attorneys' fees and experts' fees) and expenses . . . incurred in defending any Claim."[2] The insured had the opportunity to purchase defense <u>in addition to limits</u> but chose not to do so.

Due to a coverage issue, separate counsel was appointed to represent the insured and the expenses of such counsel were used by the insurer to reduce limits available for settlement. The insured protested that this was contrary to the public policy that warranted a separate coverage counsel. The court rejected this argument and found for the insurer:

> Ultimately, "insurance companies must be able to rely on their statements of coverage, exclusions, disclaimers, definitions, and other provisions, in order to received the benefit of their

> bargain, and to ensure that rates have been properly calculated." Mississippi law does not allow the courts to use rules of construction to defeat the parties' own agreement as expressed in the policy. Further, "if the insured wanted a policy that had an unlimited defense obligation, rather than an eroding one, it should have contracted for such a policy." Here the policy states that Defense Costs erode policy limits, and public policy does not bar such a provision.[3]

Excess Ins. Co. v. Doe, 511 F.3d 198 (D.C. Cir. 2008) involved a sexual abuse sublimit in a liability policy for a school. The policy stated that it would pay for investigation and defense of such claims but that such expenses would be included within limits. The court rejected the insured's attempt to parse the policy language and upheld the DWL limitation: "But the fact that the language could have been clearer of grammatically improved does not mean we can read the phrase "including investigation and defense costs" entirely out of the contact - - as [the claimant's] position would require, ..."[4]

A liability policy for a school obligated the insurer to pay Supplementary Payments in addition to limits for most claims but within limits under an endorsement for sexual abuse in *Nat'l Union Fire Ins. Co. v. Westlake Acad.,* 548 F.3d 8 (1st Cir. 2008). The Supplementary Payments covered the insurer's "expenses." The court rejected the claimant's arguments that "expenses" did not include defense costs since that would defeat the intent to pay defense costs in addition to limits on liability claims other than sexual abuse.[5]

Edwards v. Daugherty, 883 So. 2d 932 (La. 2004) involved a claims made liability policy with a DWL provision issued to a sheriff department. The insurer incurred defense costs defending the insured against liability and itself against a direct action suit and attempted to reduce limits by both types of expenses. The court noted that some other states had enacted restrictions on DWL policies but no such limitations exist on surplus lines policies in Louisiana.[6] The courts went on to rule that the defense costs which could be used to reduce limits were the insurer's costs of defending the insured, not itself:

> [T]he policy clearly contemplates that the defense to be provided is a defense of the insured. The policy makes no mention of a defense separately provided to the insurer to defend direct actions arising out of the occurrence; nor does it mention a defense of claims for penalties brought directly against the insurer and arising out of the insurers' conduct.[7]

A reduction in limits due to defense costs for an extended period to report medical malpractice claims provided the backdrop for *W. Va. Mut. Ins. Co. v. Vargas,* 933 F. Supp. 2d 847 (N.D. W.Va. 2013). The plaintiff claimed that the DWL provision violated public policy of the state due to: (1) an earlier case finding the a DWL provision violated limits mandated by statute for ambulance companies; and (2) a state statute that required doctors to maintain certain limits to qualify for a cap on medical malpractice claims. The court rejected both arguments ruling that no particular limits for medical malpractice was required by state law.

III. Case Law Finding DWL Provisions Ambiguous

IV.

An example of a contrary rule is *Branning v. CNA Ins. Co.,* 729 F.Supp. 728 (W.D. Wa. 1989) which involved a policy with a two-part limit of liability provision, the first part dealing with losses and the second with claims. The DWL provision focused on losses and not claims and the claimant sought to benefit from ambiguity in the policy form. The court found for the claimant ruling:

> The court finds the necessity of having to juxtapose three different clauses appearing on different pages, combined with the choice of policy language that simultaneously used the separate terms of "claims" and "Loss", in the absence of any clear statement that defense costs are included within the cap, creates sufficient uncertainty as to the intended meaning of the insurer.[8]

In *Weber v. Indem. Ins. Co. of N. Am.*, 345 F. Supp. 2d 1139 (D. Hi 2004), the limits applied to "all loss, damage or expense" resulting from any one accident or event. The insurer argued that "expense" included defense costs but the term was undefined and the court found it to be ambiguous. "Given that the term 'expenses' is ambiguous, it follows that the term is construed against [the insurer]."[9]

See also, Bankers Trust Co. v. Old Republic Ins. Co., 7 F. 3d 93 (7th Cir. 1993) in which it appears that the policy language netted defense costs off the deductible rather than the limits.

V. Public Policy Issues

There is a policy argument is that DWL provisions create a conflict of interest between insurers and policyholders. The rationale is that insurers, which control the defense of claims, may choose to defend rather than settle while the insured may prefer to settle rather defend. If the insurer's defense is unsuccessful, there may be insufficient limits remaining to pay claims. These arguments have had a significant influence on certain case law, statutes and regulations.

NIC Ins. Co. v. PJP Consulting, LLC, 2010 U.S. Dist. LEXIS 113207 (E.D. Pa) was a coverage action filed by an insurer in response to claim against its insured in state court pursuant to an Assault and Battery Endorsement to a liability policy purchased by a bar. Defense costs eroded available limits and the insured claimed that the DWL clause violated public policy. The federal court found that there was no applicable Pennsylvania law on point and decided to defer to state courts. However, the federal court questioned whether the DWL clause is consistent with Pennsylvania public policy noting that Minnesota, Oregon and New York have statutory or regulatory restrictions which limit the classes of business in which they can be used, require prior insurance department approval or restrict the amount of limits that can be reduced by defense costs.[10]

A collision between a motorcycle and an ambulance provided the factual backdrop for *Gibson v. Northfield Ins. Co.,* 631 S.E. 2nd 598 (W. Va. 2005). State law required that the municipality that was

responsible for the ambulance have $1 million in liability limits. The applicable policy had a DWL clause which the plaintiff argued was against public policy since it reduced available limits in violation of state law. The court agreed, ruling that:

> [A] provision in a motor vehicle insurance policy which tends to limit, reduce or nullify that statutorily-mandated liability coverage such as a "defense within limits" or similar provision that allows defense costs and litigation expenses to be deducted from the limits of liability coverage is void and ineffective as against public policy.[11]

Edwards v. Daugherty, supra, upheld DWL under Louisiana law but noted restrictions in other states. The court characterized Arkansas as requiring a company issuing DWL policies to offer limits for expenses equal to the liability limits. The court further cited, Colorado, Montana and Oregon as states that retain the right to disapprove policies contained DWL policies and/or require special disclosures.[12] Since the date of this decision, Louisiana adopted RS 12:1964(27) which makes it an unfair insurance practice to fail to disclose to an insured, upon issuance or renewal of a policy, that it contains a DWL provision.

See also, Nebraska Bulletin CB-102 in which the insurance department noted its policy to approve DWL provisions only with respect to certain classes of commercial insurance but also adds additional requirements for disclosure, minimum limits and a requirement that the insurer extend limits to the minimum required by law.

VI. **Commentary**

Defense within limits provisions clearly provide more underwriting certainty for classes of commercial liability policies that produce high defense costs and which are provided to sophisticated insureds. However, caselaw and legal and regulatory developments indicate that use of such provision for other classes of business or other types of insureds greatly increases the possibility that the provisions will be found to be ambiguous or will generate regulatory backlash.

Endnotes

1 *Edwards v. Daugherty,* 883 So. 2d 932, 941-2 (La. 2004).

2 850 F.3d 187 at 192 (internal citations omitted).

3 *Id.* at 198 (internal citations omitted).

4 511 F.3d 198 at 202.

5 548 F. 3d 8 at 18-19.

6 883 So. 2d 932 at 943.

7 *Id.* at 946.

8 729 F. Supp. 728 at 732.

[9] 345 F. Supp. 1139 at 1149.

[10] 2010 U.S. Dist LEXIS *9.

[11] 631 S.E. 2d 598 at 606.

[12] 883 So. 2d 932 at 943.