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EMERGING CLAIMS FOR INSURER BAD FAITH BASED ON THE CONDUCT OF THE DEFENCE UNDER ERODING LIMITS POLICIES

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Policyholder advocates increasingly are testing out a bad faith theory aimed at insurers when their policies include the costs of defence within the coverage limit. There are many settings where policyholders may seek to advance this emerging bad faith theory because, in a broad array of commercial insurance policies, defence costs are within policy limits and therefore reduce or erode those limits. An example of defence-within-limits language provides that "any amount otherwise payable for damages under this coverage shall be reduced by amounts paid or incurred by the company in defence of any claim or suit against the insured". Under defence-within-limits policies, every dollar spent on defence correspondingly reduces the amount available to settle or otherwise resolve a claim. And, when there is significant litigation against the policyholder, defence costs can be substantial and thus can greatly reduce or even eliminate the policy limits available to pay any settlement or judgment.

Insurers and their policyholders frequently have clashed about what constitute reasonable and necessary defence expenses, and what guidelines are appropriate for the conduct of a defence. But those disputes usually centre on the insurer's ability to insist on hourly rates consistent with the market, or to limit litigation to necessary activity undertaken in the insured's defence. See, for example, *Pepsi-Cola Metropolitan Bottling Company v Insurance Company of North America*, 2010 US Dist. LEXIS 144401 (CD Cal, 28 December 2010) (application of billing guidelines and reduced rate for independent counsel did not breach the duty to defend; guidelines were applied objectively to reduce overall fees and eliminate needless litigation costs); *Aquino v State Farm Insurance Company*, 793 A.2d 824, 832 (NJ Super 2002) ("While [the insured] may have been entitled to an attorney of his selection to handle the claim of intentional conduct, he does not have the right to dictate to the insurers the hourly rate they must pay"); *Northern Security Insurance Company v RH Realty Trust*, 78 Mass. App. Ct. 691, 695 (2011) (finding that the insured was entitled to have a reasonable fee paid, based on market rather than panel rates); *Morgan v Chicago Title Insurance Company*, 2008 US Dist. LEXIS 22628, at *10-15 (D Haw. 20 March 2008) (reducing defence counsel's time to eliminate unnecessary and irrelevant work on motion); *Pfeifer v Sentry Insurance*, 745 F. Supp. 1434, 1445 (ED Wis. 1990) (finding excessive the amount of hours billed by defence counsel for research); *Kooyman v Farm Bureau Mutual Insurance Company*, 315 N.W.2d 30 (Iowa 1982) (finding fact issues concerning whether defence counsel's inadequate preparation reflected insurer indifference to policyholder interests and thus supported bad faith claim); and In re Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedures, 2 P.3d 806 (2000) (insurer's prior approval requirements, and threat of withholding payment interfered with exercise of independent judgement by defence counsel).

Now, policyholder advocates are turning the tables and arguing that insurers are not adequately controlling costs of defence that erode their policy limits, and are thereby jeopardising the interests of their policyholders. In other words, in these emerging bad faith claims, policyholders argue that insurers must control the activities and rates charged by defence counsel more tightly, to avoid depletion of the policy limits. For instance, in *Pueblo Country Club v AXA Corporate Solutions Insurance Company* 2007 WL 951790 (D. Colo. 28 March 2007), the policyholder charged that the insurer had improperly refused to settle when its limits were being eroded by the insurer's conduct of the defence. In that case, the insurer was denied summary judgment on bad faith failure-to-settle allegations that it "was aware that attorneys' fees and costs were reducing the available policy limits and that [the insured] was exposed to a judgment in excess of the available limits, and nevertheless acted unreasonably with regard to settlement of the case." In another case, *NIC Insurance Co v PJP Consulting*, LLC, No. 09-0877, 2010 WL 4181767 (ED Pa. 22 October 2010), a federal district court judge declining jurisdiction over a declaratory judgment action in favour of a competing suit in state court commented on the issues created by defence-within-limits provisions, noting that some regulators and legislators have limited or barred them because of the conundrum faced by the policyholder that might lose protection against a judgment or settlement due to the costs of defence being applied against the policy coverage. Policyholders are increasingly challenging insurers' erosion of coverage through defence expenses, pointing to statutory and regulatory restrictions on the use of defence-within-limits provisions, for example, in Minnesota, Minn. Stat. Ann. § 60A.08 subdiv. 13; New York, NY Comp. Codes R. and Regs. Tit. XI § 71.3; and Oregon, Or. Rev. Stat. § 742.063(1). These new claims seek to alter settled law in which courts have applied defence-

within-limits provisions in a straightforward manner, even when they eliminate an obligation to pay for settlement or judgment. For years, the majority of courts have enforced the contract language of eroding limits policies, despite policyholder claims of ambiguity or confusion. See, eg, *National Union Fire Insurance Company of Pittsburgh, PA v West Lake Academy*, 548 F.3d 8 (1st Cir. 2008).

Policyholder advocates contend that their new bad faith claims pose a series of still largely unanswered questions. By charging bad faith, they are asking courts to determine the obligations owed by the insurer with a defence-eroding-limits policy. Is it bad faith for the insurer not to closely monitor the cost and conduct of the defence to avoid unreasonable and unnecessary expenses, particularly because such expenses reduce the available coverage limits and therefore increase the risk of excess liability to the policyholder? Do the same standards apply where the policyholder is defended by independent counsel as when insurer-appointed counsel acts as defence counsel? What about the use of billing guidelines and approved market billing rates? Must the insurer keep the policyholder informed of the amount of defence costs being incurred, so that the insured will be aware of the extent to which coverage has been reduced and the risk of excess liability increased? If so, how frequently must reports on the erosion of limits be made? And, what weight must the insurer give to the policyholder's desire to preserve coverage limits for indemnification of any settlement or judgment and does this consideration factor into a determination of whether the insurer should accept an offer of settlement?

Given the contentions being raised by policyholders who have depleted their coverage limits through defence, are conflicts of interest presented between the insurer and insured in defence-eroding-limits policies with respect to the conduct of the defence, including in steps such as the selection of counsel, determination of necessary discovery and litigation strategy, and/or in evaluating possible settlement of the case? The law is already somewhat mixed in articulating the standards for the insurer's exercise of the right to accept or reject a settlement within the policy limits. Some courts require an insurer to consider the insured's interests at least equally with its own when evaluating a potential settlement. Here, if a settlement is possible within the limits of a policy, policyholder advocates will likely argue that the insurer should be required to obtain the insured's consent before refusing any such offer of settlement, or face bad faith liability in the amount of any excess judgment. Another question is whether future cases under defence-within-limits policies will become candidates for court consideration of a duty to initiate settlement, an issue recently highlighted but ultimately not reached under California law in *Du v Allstate Insurance Company*, 697 F.3d 753 (9th Cir. 2012) (corrected decision, replacing opinion at 681 F.3d 1118 which had suggested such a duty). Certainly where the insurer has sufficient information to initiate settlement discussions prior to any settlement demand from the policyholder, it is likely that policyholder advocates will assert that a duty to initiate settlement should be imposed. Although the majority of courts have declined to impose an affirmative duty to initiate settlement on insurers, a few courts have suggested that, in limited circumstances, such an obligation may exist. See, for example, *Powell v Prudential Property & Casualty Insurance Company*, 584 So. 2d 12, 14 (1991) (suggesting a duty to initiate settlement where insured's liability is clear and there is a likelihood of an excess judgment); *Rova Farms Resort, Inc v Investors Insurance Company*, 65 NJ 474 (1974) (same, unless the insured refuses to contribute and there is no realistic possibility of within-limits settlement).

There are important policy considerations at stake in courts' consideration of these emerging claims. Although there is temptation to sympathise with the policyholder's plight in a case where protection against the costs of a judgment or settlement is lost due to an expensive defence, courts must consider the larger picture. Any standards governing how a defence is to be conducted should be even-handed rules. And, courts must consider whether the affirmative settlement duties that policyholders advocate for insurers would simply increase claim costs, delay case resolution by eliminating the incentives for plaintiffs to make early settlement demands within policy limits, require insurers to bid against themselves in negotiations, enhance plaintiffs' lawyers' ability to recover for nuisance suits, and serve to increase the costs of insurance for all.

Until more court guidance emerges, insurers must evaluate on their own how to respond to policyholder claims of bad faith arising from allegedly unnecessary erosion of policy limits in defending under defence-within-limits policies. In response to these types of allegations about the handling of a claim, the insurer must consider whether to take steps to eliminate continuing charges that it is improperly eroding the policy limits. For instance, on an individual claim, the insurer might evaluate whether to offer independent counsel and let the insured control the defence in order to limit potential bad faith exposure. Certainly, insurers must be sensitive to charges that policy limits are being eroded unnecessarily. Insurers may want to take additional steps to work closely with defence counsel to control costs and avoid depletion of the policy limit, carefully considering early opportunities for settlement. These considerations are particularly true where charges are made about unnecessary erosion of limits through efforts of insurer staff counsel under a defence-within-limits policy.

The emerging claims of insurer bad faith under defence-within-limits policies underscore the fact that important questions about the insurer-policyholder relationship can arise through the conduct of the defence and depletion of limits under such policies. Ironically, in many cases, policyholder arguments about what an insurer should do to control defence expenditures on defence-within-limits claims represent a role-reversal from the common policyholder objections to insurer efforts to manage and contain defence costs and activity under liability policies with a defence outside limits. It will be interesting to see whether recognition of this irony will serve as a brake on policyholder advocacy or on courts' enthusiasm for the contentions advanced by insureds about insurer obligations in this setting. Right now, the law is still developing and insurers must remain aware of the types of claim-handling allegations that have been made, as well as any new guidance from the courts on their duties under eroding limits policies.