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Avoid being burned by a burning limits policy

If the costs of a defense come out of the policy limit, you need to know that early in the case

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What happens when you have advocated, litigated, and readied your case for mediation only to be told by the mediator that one defendant has a burning limits policy and a significant portion of the policy has been spent on defending the action? It is important to recognize a burning limits policy early in the case, and to devise a strategy to deal with it.

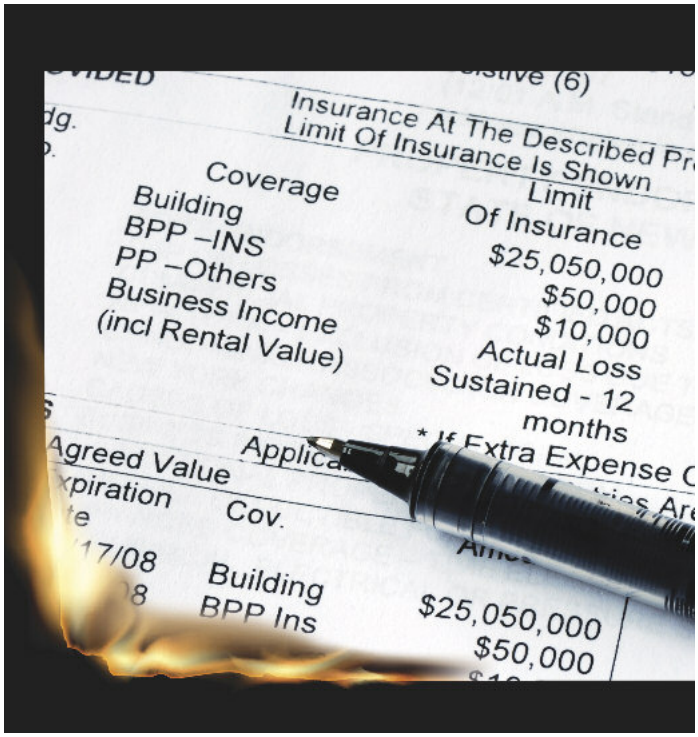
Burning limits policy

Under most liability insurance policies, the insurance carrier has dual duties to defend the claim and indemnify the insured against liability. Under a burning limits policy (also known as an eroding, wasting, defense-within-limits, self-consuming, or exhausting policy), defense costs and expenses reduce the limits of the policy. For each dollar spent defending the action (including hourly fees for attorneys to defend the lawsuit, expert consultants and witnesses, and all other costs and expenses of defending a claim), one less dollar is available for your client. Such a policy caps an insurance company's total exposure, decreases the amount available for settling or satisfying a judgment, and presents unique strategic and ethical concerns for all parties.

Not only does a burning limits policy impact how much a plaintiff may recover, it may severely impact the defendant, which a plaintiff can use to his or her advantage. A burning limits policy places pressure on the insurer, insured, and defense counsel and creates a potential conflict of interest between the three.

The conflict of interest may arise in litigation and settlement strategy. The insurer and/or defense counsel may want to pursue costly litigation to fight on the merits or to protect their reputation. On the other hand, the insured has an interest in protecting the insured's assets by settling a claim within the policy limits.

The insured's concerns are compounded by the fact that, once the policy limits are exhausted by resolving claims or by defending the claim, an insurer's obligation to provide a defense as well as indemnity may terminate. If the claim exceeds the policy limits left after defense costs have been paid, it will be the insured who will have to cover the remainder. This exposes the insured to litigation costs and any settlement or judgment once the policy has been exhausted. Given the potential conflict of



interest, the insurer may be faced with lawsuits from its insured, including allegations of bad faith.

Given the impact that a burning policy may have on a case, courts across the nation have interpreted, upheld, or denied burning limits policies differently. California has upheld defense-within-limits policies when the policy explicitly defines the loss as including the defense costs. (*Continental Insurance Company v. Superior Court* (*Baumgartner*) (1995) 37 Cal.App.4th 69 [Loss includes "damages, judgments, settlements and costs, charges and expenses incurred in the defense of actions, suits or proceedings and appeals therefrom."].)

Although more typical in professional liability, directors' and officers' liability, and employment practices liability policies, some insurance companies include defense-within limits provisions in other types of policies. Policies also differ regarding when defense costs start eroding the policy limits (e.g., after a certain expense allowance or deductible is spent). Therefore, it is

important to know the full scope of the policy early in the case to prevent learning about a burning limits policy after significant attorneys' fees have been incurred. Written discovery is the first step.

Discovery to identify the policy

For each policy, Form Interrogatory 4.1 requires the responding party address:

(a) the kind of coverage;
(b) the insurance company;
(c) each named insured;
(d) the policy number;
(e) the limits of coverage for each type of coverage contained in the policy;
(f) whether any reservation of rights or controversy or coverage dispute exists between the responding party and the insurance company; and
(g) the custodian.

A response to this interrogatory may not specifically reveal that the defendant has a burning limits policy or the full scope of the policy. Most importantly for resolving the case, the defendant's response to the policy limits subsection will not identify the amount that will be available to settle a claim or to satisfy a judgment since, in a burning limits policy, that number will be decreasing with each hour defense counsel spends on the case. To prevent any surprises late in the litigation, the policy should be flushed out more fully through other discovery.

Requesting a copy of the full policy – not just the declaration page – is important to knowing the ins and outs of the defendant's insurance coverage. If defendant refuses or delays in producing the full policy, move to compel. Under California Code of Civil Procedure section 2017.210, a party is entitled to discover the "existence and contents of any agreement under which any insurance carrier may be liable to satisfy in whole or in part a judgment that may be entered in the action or to indemnify or reimburse for payments made to satisfy the judgment. This discovery may include the identity of the carrier and the nature and limits of the coverage. A party may also obtain discovery as to whether that insurance carrier is disputing the agreement's coverage of the claim involved in the action, but not as to the nature and substance of that dispute." The available policy limits and the costs spent defending the action to date are justifiably also encompassed by section 2017.210 since it impacts the "nature and limits of the coverage."

California courts have ruled that section 2017.210 allows discovery by any method of discovery. (See *Irvington-Moore, Inc. v. Superior Court* (1993) 14 Cal.App.4th 733, 739 ["Had the Legislature intended to limit discovery of insurance information to particular methods of discovery, it would have done so by adding such a provision to the code section or sections which deal specifically with a particular method or methods of discovery."].) So all forms of discovery, including requests for production, special interrogatories, and depositions are fair game to discover the type, content, and limits of the policy.

Once you have received the policy, read it carefully. To be enforceable, the policy must expressly state that the defense costs reduce the limits of the policy. (*Haynes v. Farmers Ins. Exchange* (2004) 32 Cal.4th 1198 ["[T]o be enforceable, any provision that takes away or limits coverage reasonably expected by an insured must be conspicuous, plain and clear. Thus, any such limitation must be placed and printed so that it will attract the reader's attention."]) Look for how losses are defined or any clause that states that the limits of liability are reduced by the costs of legal defense. Consult with coverage counsel if you have any questions.

So defendant has a burning limits policy

If you have determined that defendant has a viable burning limits policy, think strategically. Protect your client's interests by litigating judiciously while minimizing defense fees and costs. Engage in early resolution of the case to maximize the money to your client but be cognizant when making a policy limits demand since the available limits are constantly changing.

Overall recognizing a burning limits policy early is crucial. If you are faced with an insured with a low policy limit, minimal assets, and a burning limits policy, it is important to engage in settlement talks early before the insurer and defense counsel have spent the policy, or a significant portion of it, defending the action.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