Document généré le 4 avr. 2025 09:39

Assurances

Assurances

Inclusion of Defense Costs in Policy Limits: An Analysis of the Potential for Failure of a Policy Form

Martin Rosenberg

Volume 58, numéro 4, 1991

DOSSIER RESPONSABILITÉS ET ASSURANCES DE RESPONSABILITÉ

URI : https://id.erudit.org/iderudit/1104804ar
DOI : https://doi.org/10.7202/1104804ar

Aller au sommaire du numéro

Éditeur(s)

HEC Montréal

ISSN

0004-6027 (imprimé)
2817-3465 (numérique)

Découvrir la revue

Citer ce document

Rosenberg, M. (1991). Inclusion of Defense Costs in Policy Limits: An Analysis of the Potential for Failure of a Policy Form. *Assurances*, *58*(4), 503–523. https://doi.org/10.7202/1104804ar

Résumé de l'article

L'un des objectifs d'inclure les frais de défense de l'assuré dans le montant d'assurance responsabilité est de permettre à l'assureur de mieux contrôler les coûts inhérents. Cet article tente de faire la lumière sur cet objectif sous l'angle des obligations de l'assureur : la défense, la contestation et le règlement du sinistre. L'auteur conclut que l'inclusion des frais de défense dans le montant de la garantie fait en sorte que l'assureur et l'avocat mandaté pour la défense ne respectent pas pleinement leurs obligations vis-à-vis l'assuré. Plus encore, l'auteur signale la perspective d'un conflit d'intérêt entourant le mandat de l'assuré, dans telle circonstance, ainsi que les possibilités de poursuites en responsabilité professionnelle par l'assuré contre ce dernier.

Tous droits réservés © Université Laval, 1991

Ce document est protégé par la loi sur le droit d'auteur. L'utilisation des services d'Érudit (y compris la reproduction) est assujettie à sa politique d'utilisation que vous pouvez consulter en ligne.

https://apropos.erudit.org/fr/usagers/politique-dutilisation/

érudit

Cet article est diffusé et préservé par Érudit.

Érudit est un consortium interuniversitaire sans but lucratif composé de l'Université de Montréal, l'Université Laval et l'Université du Québec à Montréal. Il a pour mission la promotion et la valorisation de la recherche.

https://www.erudit.org/fr/

Inclusion of Defense Costs in Policy Limits: An Analysis of the Potential for Failure of a Policy Form[1]

by

Martin Rosenberg[2]

L'un des objectifs d'inclure les frais de défense de l'assuré dans le montant d'assurance responsabilité est de permettre à l'assureur de mieux contrôler les coûts inhérents. Cet article tente de faire la lumière sur cet objectif sous l'angle des obligations de l'assureur : la défense, la contestation et le règlement du sinistre. L'auteur conclut que l'inclusion des frais de défense dans le montant de la garantie fait en sorte que l'assureur et l'avocat mandaté pour la défense ne respectent pas pleinement leurs obligations vis-à-vis l'assuré. Plus encore, l'auteur signale la perspective d'un conflit d'intérêt entourant le mandat de l'assuré, dans telle circonstance, ainsi que les possibilités de poursuites en responsabilité professionnelle par l'assuré contre ce dernier.

Overview

This article examines how the defense-within-limits policy affects the ability of the insurer and the defense attorney it hires to meet their obligations to the insured with regard to claim settlement. The DWL policy is one in which the insurer's maximum liability for any claim is the policy limit of liability reduced by the amount

[1] Republished from the *Journal of Insurance Regulation*, Vol. 16, No. 4, (June, 1990) at pp. 446-462, with the permission of the *Journal of Insurance Regulation* and the National Association of Insurance Commissioners. The views expressed in this article are those of the author, and they are not necessarily the views held by anyone else or by anything else.

[2] J.D., Rutgers University School of Law at Camden, N.J.; M.A. & B.A., Queens College. The author is a Fellow of the Casualty Actuarial Society and a Member of the American Academy of Actuaries. He is Managing Casualty Actuary, New Jersey Department of Insurance.

the insurer incurs on the cost of defending against the claim.[3] By putting a limit on the cost of defense, the DWL policy form is intended to address the "inherent problem of unlimited defense costs associated with certain insurance lines."[4]

An insurer may believe that a DWL policy form is useful to control the insurer's liability for defense costs for the various claims that may arise against the insured under the policy. Without including defense costs in the settlement amount, there may be no limit to the expenditures on defense costs. Including defense costs in the settlement amount may be seen as merely another means by which the insured shares the claim with the insurer.

The principle of the insured sharing the cost of the claim with the insurer is not *per se* objectionable. Policy forms that have been in use for many years provide for the insurer and insured sharing the loss. For example, one purpose of co-insurance in fire policies is to share the loss with the insured when the insured buys an inadequate amount of coverage. As another example, deductibles are used to relieve insurers of the expense of dealing with relatively small losses.[5] Nor is it necessary to reduce the limit of liability by defense costs in order to price liability insurance to be profitable.

Actuarial ratemaking procedures have been developed over the past 20 years to price liability insurance at a profitable level, even without reducing the limit of liability by defense costs.[6] There is no actuarial need for the limit of liability to be reduced by defense costs.

This article concludes that, instead of controlling the cost of defense, *the DWL policy may place the insurer in a position of having no* limit on its liability for the cost of defense and *no limit on its liability for the claim.*

---

[3] NAIC PROCEEDINGS, 1986, II, 743. The DWL policy form was originally proposed by ISO in 1985 for its Commercial General Liability ("CGL") policy. *See* Dorsch, *Insurance Defense Costs and the Legal Defense Cost Containment Program: Is the Free Ride Over?*, 53 INSURANCE COUNSEL J. 580, 582 (October 1986).

[4] NAIC PROCEEDINGS, 1986, II, 743.

[5] C.A. KULP AND J.W. HALL, CASUALTY INSURANCE 41, 47 (Fourth Edition 1968); HEAD, INSURANCE TO VALUE (1971).

[6] Lange, *General Liability Insurance Ratemaking*, 53 CASUALTY ACTUARIAL SOC. 26 (1966); McManus, *General Liability Ratemaking: An Update*, 67 (1980).

The National Association of Insurance Commissioners (NAIC) has raised several questions regarding the use of the DWL policy and has recommended a moratorium on its use.[7] The various states have taken different stances about regulating the DWL policy.[8] Informed conversations with several insurance departments indicate that the appropriate regulatory stance toward DWL policies is still developing. This article notes some of the important issues that should be considered.

Use of New Jersey Case Law

This article uses New Jersey case law to explore the individual and joint obligations of the insurer and the defense attorney to the insured when they settle claims on behalf of the insured. Case law is examined because the liability for not properly discharging responsibilities to the insured will very likely be determined by a court. The case law of a single state is used rather than that of every state in order to keep the article to a manageable length. The analysis of one state's case law is useful even though the obligations to the insured may vary by state because case law illustrates the nature of issues that may arise in one state and reflects how common law has been developed where statutory guidance has been unavailable. Examples illustrate the consequences that may result from using the DWL policy.

Introduction to the DWL Policy

In the typical liability insurance policy, the insurer agrees 1) to pay damages on behalf of the insured and 2) to investigate and/or defend any claim to which the policy applies. A maximum amount (called the "limit of liability") which the insurer must pay on behalf of the insured is stated in the insurance policy.[9]

---

[7] NAIC PROCEEDINGS, 1986, II, 743.

[8] As of the time the research on this article was completed, no DWL personal lines policy has been approved in New Jersey, and, pending promulgation of a regulation, New Jersey has ceased approving DWL policies which are subject to regulation under the Commercial Insurance Deregulation Act, N.J. STAT. ANN. §§ 17:29AA-1 *et seq* (West 1985). Other states have also restricted the use of the DWL policy form. *See*, for example, N.Y. ADMIN. CODE TIT. 11, §§ 71.3, 71.4 (1989); and Kentucky Department of Insurance Bulletins 87-5 (June 22, 1987) and 87-6 (July 9, 1987).

[9] KULP AND HALL 81-98.

A liability policy may provide for payment of defense costs in one of two alternative ways. First, the limit of liability may apply *only* to losses. (Hereinafter this policy form is referred to as the "standard" policy form.) Expenditures by the insurer on defense costs do not reduce the portion of the policy limit of liability which is available to pay losses. This method is the most common way of handling defense costs in liability policies.

The second — the DWL policy — limits the insurer's total limit of liability to the sum of losses and defense costs.[10]

506

Example One

A simplified example will show how the DWL policy form works.

Assume an insured has chosen a policy limit of liability of $50,000. Assume further that a claimant sues and wins an award of $40,000. If the insurer's defense costs are greater than $10,000, the insured must contribute to the settlement.

---

[10] In this article we use, for numerical examples, the DWL policy form in which the portion of the limit of liability that remains to pay claims is the original limit of liability reduced by the entire expenditure on defense costs. However, several other types of DWL policies have also been discussed, including 1) prohibiting the reduction in the portion of the limit of liability available to pay claims until some threshold amount has been spent on defense costs, and then by only the portion in excess of the threshold amount (see Dorsch, *supra* Note 3, at 582); and 2) putting a maximum on the amount to which the portion of the limit of liability that is available to pay claims can be reduced (see N.Y. Admin Code, *supra* Note 8).

As an example of 1), assume the threshold amount is 50%. Then for a general liability policy with a limit of liability of $100,000, the portion of the limit of liability available to pay claims is reduced only for the amount of defense costs in excess of $50,000. If the insurer incurs $49,000 in defense costs, $100,000 is available to pay claims. If the insurer incurs $53,000 on defense costs, $97,000 is available to pay claims.

As an example of 2), assume the maximum that the limit of liability can be reduced is 25%. If the limit of liability is $100,000, then no matter how much are the defense costs, at least $75,000 must be available to pay claims.

What all types of DWL policies have in common is that, under some circumstances, the portion of the limit of liability that is available to pay claims is reduced by expenditures on defense costs. This article critically assesses the impact of reducing the portion of the limit of liability that is available to pay claims. Therefore, use of numerical examples based on a DWL policy in which defense costs from the first dollar reduce the insured's coverage is appropriate to illustrate the potential problems associated with using the various types of DWL policy forms.

Circumstances In Which the DWL Policy Reduces the Insurer's Liability

The DWL policy will be an advantage to the insurer only if the sum of losses and defense costs is limited by the policy limit of liability. If the sum of losses and defense costs is less than the limit of liability, it is immaterial to the insurer whether the insured has a DWL policy or a standard policy.

Example Two

Assume an insured has selected a liability limit of $75,000. If a claim costs $15,000 and the defense costs are $8,500, the total liability of the insurer is $23,500 (= $15,000 + $8,500) whether the policy is a DWL policy or a standard policy. Indeed, if the sum of losses and defense costs is $75,000 or less, there is no advantage to the insurer of using the DWL policy because with the sum of losses and defense costs under $75,000, the insured pays no portion of the settlement.

Example Three

Assume an insured has selected a liability limit of $75,000. If a claim costs $70,000 and defense costs are $12,300 under a standard policy, the insurer's liability is $82,300 (= $70,000 + $12,300) because the limit of liability applies only to the losses; the insured pays no portion of the defense costs. Alternatively, under a DWL policy, the liability of the insurer is limited to $75,000. The insured would be liable for $7,230 ($82,300 - $75,000). Thus in Example Three the DWL policy is an advantage to the insurer.

What can go wrong with the DWL Policy Form

Since it is common for policy forms to provide that the insurer and the insured share the cost of the claim, why then is the DWL policy potentially troublesome? The answer is that the DWL policy form may fail to put an upper limit on defense costs. It may actually increase the possibility that the insurer will have no limit on its liability for a claim and no limit on its liability for the related defense costs.

This article concentrates on the following four problems that show how the DWL policy may fail.[11]

1) In the course of settlement negotiations, the insurer may receive a proposal to settle a claim at a specified amount. The DWL policy increases the potential for conflicts of interest between the insurer and the insured as the insurer decides whether to take the opportunity to settle the claim for the proposed amount, or to contest the claim further.

2) The DWL policy may cause the insurer to be liable for failure to meet the obligation to inform the insured of the insured's potential liability for a claim in enough time so that the insured can protect himself.

3) The DWL policy may provide a financial incentive for the insured to try to settle the claim on his own, even though the insurance policy usually proscribes this action.

4) The attorney hired by the insurer to settle the claim against the insured may be placed in a position of conflict of interest, and, therefore, subject to a malpractice action, because the attorney must advance the different interests of both the insured and the insurer. The potential conflict of interest that may arise as the attorney tries to advance the interests of two different parties is not unique to the DWL policy. However, use of the DWL policy increases the number of situations in which a conflict of interest may develop.

These problems may arise because under the DWL policy, as the insurer spends money to defend a claim, the portion of the amount available to pay the claim decreases. This decrease in the amount that remains to pay the claim may have a detrimental effect on the insured. By causing a detriment to the insured, the insurer and the defense attorney hired by the insurer may be liable to the insured.

The subsection that follows discusses one way in which the interests of the insurer and insured may conflict when the insurer is deciding to settle a claim. The next subsection discusses what are

---

[11] There are also other problems associated with the DWL policy. See NAIC PROCEEDINGS, 1986, II, 742.

the obligations that the courts have imposed on insurers with regard to settlement for an amount that is covered by the policy. The remaining subsections discuss the insurer's obligation to inform the insured when there is the possibility that the insured will be liable for the claim, and one action the insured can take when the insurer is not meeting its obligation to the insured. The discussion concludes with numerical examples that show why the DWL policy increases the potential for insurer liability for not meeting the insurer's obligations to the insured. In a separate section, the adverse impact of the DWL policy on the attorney's role is discussed.

Conflicting Interests Between the Insurer and the Insured About Settlement of a Claim

The interests of the insurer and insured may diverge when the insurer decides whether to settle a claim. For example, the insured always prefers the insurer to accept an offer to settle for an amount covered by the policy because the insured then faces no liability.[12] Consider Example Four.

Example Four

> Assume that the insured has purchased a standard liability policy with a liability limit of $50,000. Claimant files a claim against the insured for $90,000. Note that if the claimant wins the full $90,000 at trial, the insured will have to pay $40,000 of the settlement because the insurer is obligated to pay only $50,000. Assume further that before trial, the claimant is willing to settle for $49,000. If the insurer settles for $49,000, the insured pays no portion of the settlement.

It is not unusual for the filed complaint to request an amount ($90,000) which is much higher than the plaintiff is willing to accept prior to trial ($49,000).[13] The process of settlement is one of negotiation so that typically the initial demand is substantially greater

[12] Rova Farms Resorts v. Investors Ins. Co., 65 N.J. 474, 498, 323 A.2d 495, 508 (1974).

[13] Indeed in Rova Farms, at one point the fact pattern included the following. The claimant's attorney was willing to recommend that the claimant accept $50,000 in settlement. Rova Farms, 65 N.J. at 485, 323 A.2d at 501. The insurance company did not offer as much as $50,000, and subsequently, at trial, claimant won $225,000. Rova Farms, 65 N.J. at 481, 323 A2d at 499.

than the actual sum which will be accepted prior to trial.[14] It is a rare case where exploration of the possibilities of settlement, beyond the mere receipt of the plaintiff's demand, will not result in some substantial reduction in the amount.[15]

A conflict of interest may arise if the insurer believes that the claim is worth less than the amount at which the claimant is willing to settle. Assume, by way of illustration, that the insurer assesses the claim as worth only $40,000, instead of $49,000 at which the claimant is willing to settle prior to trial. The conflicting interests of insurer and insured can be seen by considering various outcomes to this situation:

- The insured prefers the insurer to settle at $49,000 or any other amount that is $50,000 or less because the loss will be covered by the policy.
- The insurer may take a different view. Since the insurer believes the claim is worth only $40,000, it may view settling for $49,000 as paying $9,000 (= $49,000 - $40,000) too much. Moreover, the insurer may wish to gain the reputation of being willing to fight inflated claims. Therefore, the insurer may decide to contest the claim in order to avoid paying the "extra" $9,000.
- In court, the claimant is requesting $90,000. If the claimant wins the full $90,000 at trial, what are the consequences for the insurer? The insurer must pay the full policy limit of $50,000, which is $1,000 more than the claimant was willing to settle for before trial.

What are the consequences for the insured? The insured must pay $40,000, the portion of the judgment in excess of policy limits. The insurer's decision to fight the claim exposes the insurer to an extra liability of merely $1,000, but that same decision exposes the insured to an extra liability of $40,000. It adds nothing to the discussion to say that the insured should have purchased a policy with higher limits of liability to avoid the situation where the limits of liability may not be sufficient. The relevant point is that the insured has purchased a policy with some stated limit of liability,

---

[14] R.E. Mallen and J.M. Smith, Legal Malpractice, II, 432 (Third Edition 1989).

[15] Tannerfors v. American Fidelity Fire Ins. Co., 397 F. Supp. 141, 159, 160 (1975).

and claims may occur for which the insurer may decide not to take the opportunity to settle for an amount covered by the policy.

Insurer's Duty to Minimize Insured's Liability. The insurer may be liable for the entire claim, including the portion in excess of that covered by the policy, if it does not meet its settlement obligations to the insured.[16]

In New Jersey, the standard of conduct for the insurer is to act in "good faith," as described in *Rova Farms Resorts v. Investors Insurance Company*.[17] In that case, an insured sued the insurer for lack of good faith in failing to settle a claim for an amount covered by the policy. The claim involved injury to a commercial invitee in a swimming accident. The court held in part that because the insurer did not offer the policy limits to settle the claim even though it was clear that the injury to the claimant was far in excess of the policy limits, the insurer must pay the entire claim, including the portion of the award in excess of policy limits.[18] Good faith is required because, under the policy, the insurer retains control of settlement of claims against the insured. Because the insured is proscribed from settling on the insured's own behalf, the insurer's relationship to the insured is one of inherent fiduciary obligation,[19] and the insurer has a responsibility to protect the insured.[20] Further, the insured is justified in relying upon the insurer to protect the insured and to be responsible for any judgment against the insured.[21]

What must the insurer do to act in good faith when there is a conflict of interests between the insurer and the insured? Good faith requires the insurer to consider the interests of the insured as well as its own interests in deciding whether to settle a claim.[22] Indeed in one decision where there was a divergence of interests between the

---

[16] Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954); Orlovsky, *The Insurer's Liability for Judgments in Excess of Policy Limits and the Movement toward Strict Liability: An Assessment*, NOVA L. REV. 31 (Spring, 1977); Koenen, *Bad Faith and Negligence Approaches to Insurer Excess Liability for Failing to Settle Third-Party Claims: Problems and Suggestions*, 54 DEFENSE COUNSEL J. 179 (April 1987).

[17] Rova Farms Resorts v. Investors Ins. Co., 65 N.J. 474, 323 A.2d 495, (1974).

[18] Rova Farms, 65 N.J. at 475, 507, 323 A.2d at 496, 513.

[19] Rova Farms, 65 N.J. at 492, 323 A.2d at 505.

[20] Griggs v. Bertram, 88 N.J. 347, 357, 443 A.2d 163, 168 (1982).

[21] Griggs, 88 N.J. at 356, 443 A.2d at 167.

[22] Rova Farms, 65 N.J. at 497, 323 A.2d at 508.

insurer and the insured, the New Jersey Supreme Court went further, and declared that, "(w)hile the insurer is not compelled to disregard its own interests, the insured's interests must necessarily come first."[23] The requirement to put the insured's interest first is a minority view. Courts in most other states are unwilling to go this far to favor the insured.[24]

Rova Farms also gave guidance as to what goes into the decision of the insurer to settle. A good faith evaluation not to settle requires consideration of the anticipated range of verdict; strengths and weaknesses of known evidence; history of particular geographic area in cases of a similar nature; relative appearance, persuasiveness and likely appeal of the claimant, the insured, and the witnesses.[25] The insurer must decide to take an opportunity to settle as if the insurer would be liable for the entire claim, including the portion in excess of policy limits.[26]

In addition, the insurer has an affirmative duty to explore settlement possibilities.[27] It is not enough for the insurer to wait for the claimant to make a request to settle for an amount covered by the policy. The affirmative duty to explore settlement possibilities is not imposed on insurers by the courts in all states.[28] For example, an Arizona court criticized the New Jersey decision by stating that, "[the holding in *Rova Farms*] imposes a more onerous obligation upon the insurer to seek settlement than is imposed where an actual offer of settlement within policy limits is made."[29]

How do these standards work in practice? That is, who has to show what in order to prove that the standard of acting in good faith was/was not met? The *Rova Farms* court puts the burden on the insurer. It presumed that a settlement could be reached within an amount covered by the policy unless the insurer could demonstrate

[23] Lieberman v. Employers Ins. of Wausau, 84 N.J. 325, 336, 419 A.2d 417, 422, 423 (1980).

[24] Koenen, *supra* Note 16, at 181.

[25] Rova Farms, 65 N.J. at 490, 323 A.2d at 503, 504.

[26] Rova Farms, 65 N.J. at 493, 497, 498, 323 A.2d at 505, 508.

[27] Rova Farms, 65 N.J. at 493, 323 A.2d at 505.

[28] Pat Magarick, EXCESS LIABILITY: THE LAW OF EXTRA CONTRACTUAL LIABILITY OF INSURERS, § 10.04 (1988).

[29] Fulton v. Woodford, 26 Ariz. App. 17, 21, 545 P.2d 979, 983 (1976).

that there was no realistic possibility of settlement for that amount, and the insured would not have contributed to whatever settlement figure above that sum might have been available.[30] Note that the burden is on the insurer to prove that the insured would not have contributed to any settlement figure above the policy limit. One analysis of *Rova Farms* suggests that an insurer could avoid liability for excess judgment only if 1) the insurer had offered the entire policy limit and had been rejected and 2) the insurer then sought settlement above the policy limit and had been unsuccessful only because the insured could not or would not contribute an amount that claimant was willing to accept.[31] The burden of proof that New Jersey places on insurers has been criticized as being too great.[32]

Insurer's Duty to Notify the Insured of Insured's Potential Liability for a Claim. The insurer has a duty to notify the insured when the insurance policy may not cover the claim. In *Yeomans v. Allstate Ins. Co.*,[33] an auto insurer failed to inform the insured of the virtual certainty that she would need to contribute to the settlement. The insurer also did not inform the insured until trial was imminent of its decision to commit its policy limit toward settlement.[34] The court found that the insured was deprived of any realistic opportunity of preparing to participate in a settlement above an amount that would be covered by the policy.[35]

Tannerfors involved liability for an auto accident. The insurer knew that it was likely the insured would need to contribute to the settlement but did not so advise the insured.[36] The court found this to be an "outrageous breach" of fiduciary duty.[37] The insurer was held liable for the entire claim including the portion not covered by the policy.

---

[30] Rova Farms, 65 N.J. at 496, 323 A.2d at 507.

[31] *Survey of the 1973-1974 Supreme Court Term*, 28 RUTGERS L. REV. 309, 343 (1974).

[32] One comment goes so far as to describe the court's decision as requiring that the insurer disprove causation. *See* S.S. ASHLEY, BAD FAITH ACTIONS, § 3:19 (1984).

[33] Yeomans v. Allstate, 130 N.J. Super 48, 324 A.2d 906 (App. Div. 1974).

[34] Yeomans, 130 N.J. Super at 51, 324 A.2d at 908.

[35] *Id.*

[36] Tannerfors, 397 F.Supp. at 160, 161.

[37] *Id.*

In *Griggs* an insurer denied coverage for personal liability because the policy excluded coverage for intentional torts.[38] The court decided that the insurer did not inform the insured quickly enough of the possibility of the denial of coverage with the resulting liability of the insured for the claim. Therefore, the insurer could not avoid liability. A timely disclosure of the results of any investigation must be made to the insured.[39] Such disclosure is especially important where the results of an investigation reveal that the insured may be liable for the claim.[40] Failure to give prompt notice is inconsistent with the overriding fiduciary duty of an insurer to deal with an insured fairly and candidly so that the insured can, if necessary, protect itself.[41]

Options for the Insured When Insurer Fails to Meet Its Obligations to the Insured. The insured need not wait for the insurer to settle a claim before the insured takes action on his own behalf. The terms of a liability policy typically limit the insured's right to conduct settlement negotiations. Despite the limitation on the insured's actions in the policy, the insured may be able to settle and still recover the policy limits from the insurer whenever the potential exists that the insured may be liable for the claim.

The insured need not wait for the outcome of a trial of that claim. Instead, the insured may proceed to make a prudent, good faith settlement, and then, upon proof of the breach of the insurer's obligation, and the reasonableness and good faith of the settlement that the insured negotiated, to recover the amount of the policy limit from the insurer.[42] If the insurer tries to avoid liability for the settlement reached by the insured, the insurer has the burden of demonstrating, by a preponderance of the evidence, that the insurer is not liable because the settlement reached by the insured is neither reasonable nor reached in good faith.[43]

---

[38] Griggs, 88 N.J. at 353, 354, 443 A.2d at 166.

[39] Griggs, 88 N.J. at 361, 443 A.2d at 170.

[40] *Id.*

[41] *Id.*

[42] Fireman's Fund Ins. Co. v. Security Ins. Co. of Hartford, 72 N.J. 63, 75, 367 A.2d 864, 870 (1976).

[43] Griggs, 88 N.J. at 368, 443 A.2d at 173.

Obligations of the Insurer to the Insured Under a DWL Policy

As of the time research on this article was completed, there were no reported cases in New Jersey which specifically address the obligations under a DWL policy when a claim is being settled. However, there is no reason to believe that the insurer's obligations to act in good faith, to give adequate notice to the insured of the insured's potential liability for a claim, etc., as described *supra,* are any less under a DWL policy than under a standard policy.[44]

Settling a claim within policy limits. The potential situations where there is a conflict of interest between the insurer and the insured is greater under a DWL policy than under a standard policy because under a DWL policy when the insurer defends against a claim, the remaining portion of the limit of liability decreases. Consider, in Example Five, the insurer's decision to defend against a claim which was originally within the limit of liability.

Example Five

Assume the liability limit is $60,000. A claim is filed for $59,500. Under a standard policy, the insured does not pay any part of the claim, no matter how much the insurer spends on defense costs. However, if the policy is a DWL policy, and the insurer spends, say, $5,000 on defense costs, the amount that remains to pay claims is $55,000 (= $60,000 - $5,000). If the settlement is for any amount above $55,000, the insured must contribute to the settlement. For example, if the settlement is for the full $59,500, the insured must pay $4,500 (= $59,500 - $55,000).

An insurer will investigate every claim to some extent to protect its financial interests. One purpose of the claims adjusting function is to maintain "adequate resistance to faulty, unreasonable, or questionable claims."[45] It is, therefore, unlikely that an insurer will

[44] For analyses of the potential effect of the DWL policy on the obligations of the insurer and the defense attorney made without the benefit of case law which specifically addresses the DWL policy, see Dorsch, *supra* Note 3; Ericsson, *Insurer Furor*, 15 THE BRIEF 10, 13 (Fall 1985); and Warnke, *Defense Cost Ethics: 20 Questions to Answer*, 15 THE BRIEF 15 (Fall 1985).

[45] BERNARD WEBB, J. J. LAUNIE, W. P. ROKES, N.A. BAGLINI, INSURANCE COMPANY OPERATIONS, I. 17 (1984).

merely send a check to the claimant on being informed of a demand for $59,500.

On what bases might the insured challenge the insurer's decision to use up some of the limit of liability in defense costs? To meet its fiduciary obligations, the insurer must consider the interests of the insured as well as its own interests.[46] Therefore, the insurer may have to explain how the insurer protected the insured's interest by spending $5,000 on defense costs. Is spending that amount on defense costs consistent with the insurer's obligation to handle the claim as if the insurer were liable for the entire claim? It is difficult to show the need to spend $5,000 when the claim settles for the amount originally demanded ($59,500).

Further, the insurer has an affirmative duty to attempt settlement within policy limits; the burden is on the insurer to show that a settlement could not have been reached within those policy limits.[47] With the original policy limit ($60,000) higher than the amount the claimant is demanding ($59,500), it appears that it will be very difficult for the insurer to show that a settlement could not have been reached within policy limits.

Therefore, it is possible that the insurer will be found not to have met its settlement obligations to the insured. Should this happen, the insurer may be liable for the entire amount of the claim. The DWL policy will have failed to limit the insurer's liability.

The point of this example is not to predict the outcome of any hypothetical dispute between the insured and the insurer. Instead, the key point is to show that the use of the DWL policy brings about the potential for disputes which would not exist were a standard policy used.

Settling a claim in excess of policy limits. Under a DWL policy, there is a greater potential for charges that the insurer did not act in good faith in settling a claim which is in excess of policy limits. Under a standard policy, the insurer's decision to defend against a claim instead of settling the claim may cause the insured to be liable for a portion of the claim in excess of policy limits.[48]

---

[46] Rova Farms, 65 N.J. at 497, 323 A.2d at 508.

[47] Rova Farms, 65 N.J. at 496, 323 A.2d at 507.

[48] See *supra* Note 16.

Under a DWL policy, the insurer's decision to defend against a claim exposes the insured not only to the portion of the claim in excess of policy limits, but also to the amount the insurer spends on defense costs. Thus, the insurer's decision to defend against the claim may increase the insured's liability.

The insurer has an obligation to attempt to settle within policy limits.[49] The insurer must also be willing to offer the entire policy limit in settlement.[50] The DWL policy may make it impossible for the insurer to meet both of these obligations simultaneously. To bring the claim within policy limits, the insurer may have to spend money on defense costs. However, these expenditures make it impossible to offer the entire limit of liability in settlement.

A claimant may initially demand more than the claimant is willing to accept. However, through negotiation, the claim may settle for a lower amount.[51] Nevertheless, by incurring defense costs, the insurer may put the insured in a worse position. Consider Example Six.

Example Six

Assume the limit of liability under a DWL policy is $60,000. A claim is filed for $85,000. To further the insurer's own financial interests as well as meet the insurer's obligation to the insured to investigate and negotiate to try to settle the claim, the insurer incurs $20,000 on defense costs. The claim settles for $75,000. The portion of the limit of liability that remains to pay claims is $40,000 (= $60,000 - $20,000). The insured must contribute $35,000 (= $75,000 - $40,000).

The insurer can not wait for an offer to settle by the claimant. The insurer must seek out the claimant to explore settlement possibilities.[52] However, in this example, the fact is that the insured is worse off for the settlement activities by the insurer. Had the insurer settled the claim by incurring only nominal defense

---

[49] Rova Farms, 65 N.J. at 496, 323 A.2d at 507.

[50] See *supra* Note 31.

[51] See *supra* Note 14, and Tannerfors, 397 F. Supp. at 159, 160.

[52] Rova Farms, 65 N.J. at 493, 323 A.2d at 505.

costs, the insured may have had to contribute a figure closer to $25,000 (= $85,000 = $60,000) than $35,000.

The amount spent on defense costs could be the source of a challenge by the insured. Why? Because in Example Six, the insurer's expenditure on defense costs of $20,000 means the contribution by the insured ($35,000) is greater than what would have been the amount of the insured's contribution in the presence of only nominal expenditures on defense costs. The question may arise as to how much of the defense costs were spent on protecting the insurer's interests, and how much were spent to protect the insured's interests. If it turns out that the insurer has pursued a defense, part of which proves to be needless or frivolous, the insured may attempt to recover these expenditures from the insurer.[53]

Unless the insurer can show some improvement in the position of the insured, the insurer will appear to have wasted the insured's money on defense. Even if the insurer can show that the insured agreed to permit the insurer to dispute the claim when the demand for $85,000 was made, there still might be a dispute between the insurer and the insured as to the amount spent on defense by the insurer.

Informing the Insured of the Insured's Potential Liability. For the situations represented by Examples Five and Six, *supra*, the insurer's act of spending money on defense costs works to the detriment of the insured. The insurer is obligated to inform the insured whenever the potential exists that the insured will have to contribute to the claim.[54] Consider the insured's reaction in a situation such as Example Five. The limit of liability is $60,000, and a claim is filed for $59,500. The insurer must inform the insured that there is a potential lack of coverage so that the insurer can protect itself. We can guess that the insured would react negatively to the news that while the current limit of liability ($60,000) covers the claim, the insurer plans to use up at least some of the limit of liability on defense costs.

---

[53] See Dorsch, *supra* Note 3, at 587.

[54] Tannerfors, 397 F.Supp. at 160, 161; Griggs, 88 N.J. at 361, 443 A.2d at 170.

Further, the insured will be informed that the result may be that the remaining limit of liability will not cover the claim. The insured will want the case to be settled before the remaining portion of the limit of liability is too small to cover the claim.[55] If the insured does settle on its own, the insured may demand the contribution from the insurer up to the limit of liability to the settlement. A dispute may result about the amount of contribution. Resolving the dispute would require expenditures by the insurer. In addition, the insurer may be required to pay the limit of liability. For these reasons, the use of the DWL policy may not be consistent with the goal of containing costs.

Role of the attorney

The attorney hired by the insurer to defend the insured serves two clients, the insurer and the insured.[56] How an attorney must act when the interests of the clients are potentially or actually adverse has been addressed in several New Jersey cases.

In *Bartels v. Romano*,[57] it was disputed whether an auto policy with a $25 thousand liability limit or a homeowners policy with a $100 thousand limit would cover a claim. In the course of settling the claim, the attorney hired by the insurer with the $100 thousand policy filed a complaint in the name of the insured against the insurer with the $25 thousand policy. The complaint sought a declaration of coverage under the smaller policy for allegations set forth in two of the counts. The conflict of interest in this situation is that one of the attorney's clients, the insured, prefers to have the policy with the higher limits of liability to cover the claim, while the attorney's other client, the insurer with the $100 thousand policy, prefers the policy with the lower limit of liability to cover the claim.

New Jersey courts have responded to this and similar situations by describing the attorney's duties and stating what actions the attorney should take when a conflict arises. The attorney owes the client "unswerving allegiance." The fact that the attorney

---

[55] Dorsch, *supra* Note 3, at 584.

[56] Mallen, ***Insurance Counsel: The Fine Line Between Professional Responsibility and Malpractice***, 45 Insurance Counsel J. 244 (April, 1978); Model Code of Professional Responsibility EC 5-17 (1983).

[57] Bartels v. Romano, 171 N.J. Super 23, 407 A.2d 1248 (App. Div. 1979).

is hired by the insurer does not change the attorney-client relationship with the insured. If an attorney finds that the duty to the client conflicts with the duty owed to the insurer which hired the attorney, then the attorney should not continue to represent both.[58] When a conflict of interests develops, the attorney must 1) inform the insured of the existence of the conflict and 2) either withdraw from the case or terminate representation of either the insurer or the insured.[59] Failure to meet the attorney's duty may be actionable professional malpractice by the attorney.[60] An attorney should avoid not only situations where the conflict of interest is present but even those in which a conflict is likely to develop.[61]

Consent of the Insured to Dual Representation. *In re Lanza*[62] involved the reprimand of an attorney who represented both the purchaser and the vendor of real estate. The court stated that when there is a potential conflict of interest, the attorney should inform both parties of the potential conflict "at some length and with considerable specificity."[63] Only after the attorney has received the informed consent of each of the clients should the attorney continue to represent clients with potentially adverse positions.[64] However, consent of the insured does not relieve the attorney of the responsibility to avoid conflicts of interest. After a latent conflict of interest becomes acute, the attorney should withdraw from representing either party.[65] It is untenable for the attorney to be placed in a situation where the attorney must contend for one client that which duty to another client requires the attorney to oppose.[66]

It is questionable whether an insured who is not familiar with the complexities of how insurance disputes are settled can even give

---

[58] Bartels, 171 N.J. Super at 29, 407 A.2d at 1251.

[59] Lieberman, 84 N.J. at 340, 419 A.2d at 425.

[60] *Id.*

[61] Clark v. Corliss, 98 N.J. Super 323, 327, 237 A.2d 298, 300 (App. Div. 1967).

[62] In *re* Lanza, 65 N.J. 347, 322 A.2d 445 (1974).

[63] Lanza, 65 N.J. at 352, 353, 322 A.2d at 448.

[64] Lanza, 65 N.J. at 351, 322 A.2d at 447, 448.

[65] Lanza, 65 N.J. at 350, 322 A.2d at 447.

[66] Lanza, 65 N.J. at 358, 322 A.2d at 451; Model Code of Professional Responsibility EC 5-15 (1983).

informed consent for dual representation.[67] Most lay persons are likely to defer to the attorney's professional opinion as to whether a conflict of interest will develop. Insureds do not buy an insurance policy with the expectation that they will participate in making decisions as to how many attorneys are needed to conduct the defense of a claim.

Effect of the DWL policy on the attorney's role in settlement negotiations. The attorney should assure that the insurer fulfills its good faith obligations to the insured.[68] One area of conflict may arise in the process of settling the claim. Consider Examples Five and Six, *supra*. An attorney representing both the insurer and the insured in Example Five, *supra,* would have to contend that the insurer's reduction of the limit of liability to $55,000 is proper at the same time the attorney is contending for the insured that the insurer should have settled at $59,500. The attorney in Example Six, *supra,* would have to contend that the insurer was correct in putting the insured in a position of having to contribute $35,000 toward the settlement at the same time of having to contend for the insured that the insurer should not have spent so much on defense costs.

One of the actions that may be required of the attorney is to withdraw from representing the insured after the appearance of a conflict of interest. A special problem caused by the DWL policy may occur as follows: It could happen that the defense attorney withdraws upon realizing there is a conflict of interest. The withdrawal may take place after some participation in settlement activity by the defense attorney. Therefore, some of the insured's limit of liability is used up in defense costs by the defense attorney's participation in the defense. This works to the detriment of the insured. When the defense attorney withdraws, all the insured gets in exchange for the lower limit of liability is the knowledge that the defense attorney no longer represents the insured.

Conclusion

The purpose of the DWL policy is to control defense costs. This article has shown that use of the DWL policy form may defeat this purpose in a number of ways:

---

[67] Lanza, 65 N.J. at 357, 322 A.2d at 451.

[68] MALLEN AND SMITH, *supra* Note 14, at 434, 435.

1) The use of the DWL policy increases the number of situations where the insurer can be found not to have met its settlement obligations to the insured; the insurer may be liable for the entire claim with no limit on defense costs. The insurer has a greater chance of being found liable for the entire claim under a DWL policy than under a standard policy.

2) There will be costs and uncertainty for the insurer associated with settling the suits against the insurer by the insured that arise from the use of the DWL policy.

3) Insurers will have to spend more money on claims handling procedures to document and justify expenditures on defense costs in anticipation of challenges by policyholders insured under a DWL policy.

4) The article has also shown that the defense attorney hired by the insurer may be put in an untenable position in the course of settling a claim under the DWL policy.

The challenge to insurers that wish to obtain approval from insurance regulators to use a DWL policy form is to design a claims handling procedure which will obviate the situations where the DWL policy may cause additional liability for the insurer and the defense attorney. In the absence of such a claims handling procedure, the DWL policy form should be disapproved by insurance regulators, except for the most compelling reasons.

However, the realities of the marketplace may make prohibiting the DWL policy difficult. In some markets, there may be only a few insurers, all of whom are willing to write a class of general liability only if they can do so with the DWL policy. Faced with the prospect of no insurance, potential insureds may join with the insurers in requesting approval of some form of DWL policy. Since insurance may be necessary for some persons to remain in business, the potential insureds may have no patience for hearing about technical aspects of the DWL policy that may lead to problems at some later point.

If the DWL policy cannot be prohibited, then the regulator should attempt modifications to alleviate potential problems. For example, the regulator could state a willingness to approve a DWL policy in which not all the defense costs reduce the portion of the

limit of liability available to pay claims.[69] Or the regulator could decide to find a DWL policy acceptable if it contained the provision that, regardless of the cost of defense, a minimum amount of the original limit of liability must remain available to pay claims.[70]

As an approved DWL policy is used, regulators should collect data on how much money is actually saved by insurers. Information should also be collected on suits that arise from the use of the DWL policy. A series of large awards for bad faith on the part of the insurer or a series of large malpractice awards against defense attorneys could cause insurers to reassess their use of DWL policy forms.

[69] *See supra* Note 10.
[70] *Id.*