

Revisiting The Duty to Defend After the Exhaustion of the Policy Limits

Introduction

The duty to defend and the duty to indemnify are distinct duties with the duty to defend wider in scope than the duty to indemnify. Over the last fifty years, the standard insurance policy has been revised several times as insurance companies have attempted to limit and/or clarify their duty to defend. One of the areas insurers addressed with these revisions is the insurer's duty to defend after its policy limits have been exhausted. Despite these revisions, many jurisdictions have been reluctant to allow an insurance company to pay its policy limits and terminate its duty to defend without a waiver or express language in the insurance policy. When multiple claims arise under a policy, courts have been more likely to allow an insurer to terminate its duty to defend. In both situations, courts will examine the specific facts of each case and require that the insurer act in good faith.

Lumberman's Mut. Cas. Co. v. McCarthy

The most often cited case standing for the proposition that the insurer's duty to defend can be limited is *Lumberman's Mut. Cas. Co. v. McCarthy*, 8 A.2d 750, 90 N.H. 320 (1939). In this case, two actions were initiated against the insured. *Id.*, 8 A.2d at 750, 90 N.H. at 322. Initially, the insurance company defended both actions until a final judgment was entered in one of the actions that exceeded the policy limits. After the judgment was rendered, the insurance company paid its policy limits and claimed that it was no longer obligated to defend the insured in the second action. *Id.* The relevant policy language stated that the insurer was obligated to pay "all sums which the Assured shall become obligated to pay by reason of the liability imposed upon him by law for damages" and to pay all expenses incurred in the "investigation, negotiation

or defense” of litigation for all claims that come within the policy. *Id.*, 8 A.2d at 752, 90 N.H. at 322.

In construing the terms of the policy, the court stated that the insurer’s primary obligation was to pay the insured’s legal liability for damages and that the other provisions of the policy were contingent upon the primary obligation. *Id.*, 8 A.2d at 752, 90 N.H. at 323. The court further stated that insurer was liable for the costs and expenses up until there was a final judgment “[b]ut, upon performance of its duties of payment its duty to defend ceases to exist and the further defense of any action pending thereafter must be conducted and may be controlled by the insured.” *Id.* The primary policy reason behind this holding is to eliminate the dichotomy of having the insurer defend a case where it no longer has the obligation to indemnify. Instead, it allows the insured to control the litigation and ultimately make the decision about settling or trying the case. Whether the rationale is valid is unclear, as many courts today address this potential conflict by requiring the insurer to pay for the insured’s attorney while allowing the insured to control the litigation. Edward J. Zulkey & Michael A. Pollard, *The Duty to Defend After Exhaustion of Policy Limits*, For the Defense, June 1985, at 23.

While the court held in this case that the duty to defend was properly limited, the court added in dicta that there are certain situations where the insurer cannot simply pay the policy limits and remove itself from the case. The court stated that the insurer may not “elect to pay the full limit of its coverage to the insured and thereby cast upon his shoulders the full burden of investigation, settlement or defense from the beginning.” *McCarthy*, 8 A.2d at 752, 90 N.H. at 323. Furthermore, the court stated that the insurer could not abandon its defense of a claim in the middle of litigation under circumstances that are prejudicial to the insured. *Id.*, 8 A.2d at 752, 90 N.H. at 324.

Policy Language Before 1966

Before 1966, the standard policy language stated that the insurance company will “pay on behalf of the insured all sums which the insured shall become legally obligated to pay ... and the company shall defend any suit alleging such bodily injury or property damage and seeking damages *which are payable under the terms of this policy*, even if any of the allegations of the suit are groundless, false or fraudulent; but the company may make such investigation and settlement of any claim or suit as it deems expedient.” (Emphasis in original) *Gross v. Lloyd’s of London Ins. Co.*, 328 N.W.2d 266, 269, 121 Wis.2d 78, 84 (1984)(citing E. Van Vugt, *Termination of the Insurer’s Duty to Defend by Exhaustion of Policy Limits*, 44 Ins. Couns. J. 254, 257 (1977)). It was unclear whether this policy language relieved the insurer of its duty to defend once the policy limits were exhausted. *Id.*

As there is today under the post-1966 policy language, the pre-1966 language produced a split in the jurisdictions. Some courts held that the duty to defend ceased upon the exhaustion of policy limits. *See e.g. See Commercial Union Ins. Co. v. Pittsburgh Corning Corp.*, 789 F.2d 214, 220 (3d. Cir. 1986); *Liberty Mutual Ins. Co. v. Mead Corp.*, 131 S.E.2d 534, 219 Ga. 6 (1963); *Denham v. LaSalle-Madison Hotel Co.*, 168 F.2d 576 (7th Cir. 1948). While other jurisdictions held that there is a duty to defend even after exhaustion of the policy limits through settlement or judgment. *See e.g. St. Paul Fire & Marine Ins. Co. v. Thompson*, 433 P.2d 795, 150 Mont. 182 (1967); *Simmons v. Jeffords*, 260 F.Supp. 641 (E.D. Pa. 1966). Under the pre-1966 policy language, jurisdictions that have followed *McCarthy* and allowed the insurance company to withdraw from its defense still acknowledge that the insurer cannot avoid its duty to defend by paying the policy limits early in the case and not provide a defense without procuring

a settlement or receiving permission from the insured. See *Liberty Mutual Ins. Co.*, 131 S.E.2d at 537, 219 Ga. at 11 (1963); *Simmons v. Jeffords*, 260 F.Supp. 641 (E.D. Pa. 1966).

The Post-1966 Standard Policy Language

The standard Comprehensive General Liability Policy was amended in 1966 to read:

The company will pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of:

A. Bodily injury or,

B. Property damage

To which this insurance applies, caused by an occurrence, and the company shall have the right and duty to defend any suit against the insured seeking damages on account of such bodily injury or property damage, even if any allegations of the suit are groundless, false, or fraudulent, and may make such investigation and settlement of any claim or suit as it deems expedient, *but the company shall not be obliged to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements* (emphasis added).

The italicized language in the preceding paragraph was the language added to the standard policy. The reason for the 1966 change to the standard policy language has been debated. See *Commercial Union Ins. Co. v. Pittsburgh Corning Corp.*, 789 F.2d 214, 220 (3d. Cir. 1986). The phrase “after the applicable limit of the company’s liability has been exhausted by payment of judgments or settlements” can be subject to more than one reasonable interpretation. See *id.* In *Commercial Union*, the Court of Appeals for the Third Circuit agreed with the district court that the change in the policy language was intended to clarify the limits on the duty to defend. *Id.* Other courts have interpreted the policy language to mean that the change was to prohibit the insurer from tendering the policy limits and avoiding its duty to defend. *Id.*; See *Keene Corp. v. Insurance Co. of North America*, 597 F.Supp. 946 (D. D.C. 1985), *vacated as moot*, 631 F. Supp. 34 (D. D.C. 1985).

One of the first cases to be brought under the new standard policy language was *Conway v. Country Cas. Ins. Co.*, 442 N.E. 2d 245, 92 Ill. 2d 388 (1982). In *Conway*, the insured had a

policy limit for \$10,000 for bodily injury and was involved in an automobile accident. *Id.*, 442 N.E.2d at 246, 92 Ill. at 391. The insurer then began to reimburse the other driver for injuries after the accident, which totaled \$9,736.49. *Id.* The other driver and the insurer, with the consent of the insured, agreed to pay the \$10,000 limit for bodily injury. *Id.*, 442 N.E.2d at 246, 92 Ill. at 392. The insurer, however, failed to execute a release and the other driver proceeded with her lawsuit. After the insurance company declined to defend the insured in the case, the insured personally settled with the other driver. The insured then brought suit against the insurer to be reimbursed for the settlement amount plus attorney's fees. *Id.*

The *Conway* court began its analysis by stating that in Illinois the duty to defend is distinct from the duty to indemnify with the duty to defend broader than the duty to indemnify. *Id.*, 442 N.E.2d at 247, 92 Ill. at 394. The court then recognized that jurisdictions have not all agreed upon the appropriate response to this issue and that it held that the better approach is where the insurer is not discharged when the insurer pays its policy limits. *Id.*, 442 N.E.2d at 247, 92 Ill. at 395. The court reasoned that the policy language supported this holding. *Id.*, 442 N.E.2d at 248, 92 Ill. at 395-96. The policy language read that the insurer could terminate its duty to defend if there were any judgments or settlements and, in this case, there was no judgment or settlement. *Id.*, 442 N.E.2d at 248, 92 Ill. at 396.

Many of the insurance policies that have been the subject of litigation over the last twenty years have involved policy language slightly different than the 1966 standard form. In *Gross*, the policy included the standard policy language and an additional phrase at the end of the paragraph that stated "or after such limit of the Company's liability has been tendered for settlements." The insurer wanted to pay the policy into the court and be relieved of its duty to defend. The issue before the court was whether the provision for tendering the policy limits was enforceable. The

court held that the insured never received adequate notice of the additional phrase and, therefore, the insurer was not relieved of its duty to defend. Furthermore, the court added that any change in the policy language must be in “conspicuous print, such as bold, italicized, or colored type, which gives clear notice to the insured that the insurer may be relieved of its duty to defend by tendering the policy limits for settlement.”

Insurance companies need to pay close attention to the court rulings in their jurisdiction and appropriately update their insurance policies. For example, almost 15 years after the *Gross* decision, an insurance policy in Wisconsin still did not place this same additional phrase that was in *Gross* in conspicuous print. See *Hoffman v. Economy Preferred Ins. Co.*, 606 N.W.2d 590, 232 Wis. 2d 53 (Wis. Ct. App. 1999). The insurance company in *Hoffman*, however, was able to “pay and walk” and escape its duty to defend because the insured in this case was deemed a permissive user. *Id.*, 606 N.W.2d at 593, 232 Wis.2d at 59. The court suggested that if it was not a permissive user the insurance company would have been required to defend the insured because it did not provide the phrase in conspicuous print. See *id.*

Paying Its Policy Limits Into the Court

One method an insurer can utilize to limit its duty to defend is to pay the policy limits into the court. Many of the current insurance policies have eliminated the phrase “has been exhausted by judgments or settlements” ending the policy with the phrase “has been exhausted.” Accordingly, this revision has been the subject of much of the recent litigation. Some courts have held the term “has been exhausted” is either ambiguous or means that there must be a judgment or settlement and have not allowed the insurance company to terminate its duty to defend when the insurance company wanted to pay into the court. *Douglas v. Allied American Ins.*, 727 N.E. 2d 376, 380, 312 Ill. App. 535 (Ill App. 2000); *Brown v. Lumberman’s Mut. Cas.*

Co., 390 S.E.2d 150, 326 N.C. 387 (1990); *Stanley v. Cobb*, 624 F.Supp. 536 (E.D. Tenn. 1986); *Anderson v. United Fidelity & Guaranty Co.*, 339 S.E.2d 660, 177 Ga. App. 520 (1986). These courts have held that insurer's cannot simply pay the policy limits into the court and be relieved of its duty to defend without express language in the insurance contract.

In *Brown v. Lumberman's Mut. Cas. Co.*, *supra*, the court stated that "[t]he ambiguity in the questioned provision thus lies not in the meaning of the word "exhausted." It lies in the manner by which the coverage must be exhausted before the duty to defend terminates." *Brown*, 390 S.E.2d at 154, 326 N.C. at 394. The court stated that the ambiguity is whether exhausting the limits in any manner terminates the duty or if it must be settlement or judgment. *Id.* Since the court felt that there was ambiguity in the policy language, the court ruled in favor of the insured. *Id.* This holding is similar to the holding in *Stanley v. Cobb*, *supra*, where the court found that the policy language was also ambiguous and ruled in favor of the insured. The court in this case stated that there were no provisions in the policy that gave the insurer the option of paying the policy into court. *Stanley*, 624 F.Supp. at 538.

In *Douglas*, the court found that the term "legally obligated" was not defined in the policy, in addition to "exhausted by payment" and the court wrote that under its plain meaning, one is not legally obligated to pay until a judgment or settlement is reached. *Douglas*, 727 N.E.2d at 380, 312 Ill. App.3d at 540. The court also wrote that "exhausted by payment" was not defined and was subject to more than one interpretation. *Id.* Therefore, the court ruled that the provision was ambiguous and that the insurance company had to either reach a settlement or defend the case. *Id.*, 727 N.E.2d at 383, 312 Ill. App.3d at 543.

Other courts have reached the same outcome with different reasoning. In *Anderson v. United Fidelity & Guaranty Co.*, *supra*, the court held that the policy language was not

ambiguous and that it was clear that the insurer could only terminate its duty to defend after it either reached a settlement or the court issued a judgment. *Anderson*, 339 S.E.2d 660, 661, 177 Ga. App. 520, 521 (1986). Another court did not reach the issue of ambiguity but still interpreted the provision in favor of the insured. *Samplly v. Integrity Ins. Co.*, 476 So.2d 79, 83 (Ala. 1985).

At least one jurisdiction has allowed the insurer to pay into the court and terminate its duty to defend when the policy language included language that provided that it could terminate its duty to defend when it paid its entire policy proceeds into the court. *Batdorf v. Transamerica Title Ins. Co.*, 702 P.2d 1211, 41 Wash. App. 254 (1985). In *Batdorf*, the court stated that the insurance company reserved this option to pay into the court with specific language in the insurance contract. *Id.*, 702 P.2d at 1213.

When paying the policy limits, the insurer is required to act in good faith. See *Lafauci v. Jenkins*, 2003 La. App. LEXIS 25 (La. Ct. App. 2003). Insurance companies can be held to act in bad faith for not properly evaluating a claim, refusing to settle a claim, or failing to keep the insured informed of the status of settlement claims that might affect the insured's excess exposure. *Id.* at *21, *22. In *Lafauci*, the insurer attempted to settle the case unsuccessfully and then filed a motion to deposit its policy limits with the court three months after it had filed its answer while never providing any defense to the insured. *Id.* at *22, *23. The court held that the insurer did not strictly comply with the procedural rules of tender and deposit and did not act in good faith. *Id.* at *29. The court stated that even if the procedural rules of tender and deposit were followed, the insurer did not perform the fiduciary duties of keeping the insured informed, to defend the insured until the money was deposited into the court, and protect the insured's interest. *Id.* at *23, *24.

Responding to Multiple Claims

There is another line of cases involving multiple claims against the insured where the insurer terminated its duty to defend after settling one of the claims. Courts that have ruled the policy language unambiguous believe that this policy is subject to one reasonable interpretation – that the insurer will defend or settle any claim, but there is no defense obligation once the policy limits are exhausted. See *Mid-Century Insurance Co. v. Childs*, 15 S.W.3d 187, 188. (Tex. App. 2000); *American States Ins. Co. of Texas v. Arnold*, 930 S.W. 2d 196, 201 (Tex. App. 1996); *Maguire v. Ohio Casualty Ins. Co.*, 412 Pa. Super. 59; 602 A.2d 893 (Pa. Super. 1992); *Underwriters Guar. v. Nationwide Mutual Fire Ins. Co.*, 578 So.2d 34, 35 (Fla. Dist. Ct. App. 1991); *Johnson v. Continental Ins. Co.*, 202 Cal. App. 3d 477, 248 Cal. Rptr. 412 (Cal. Ct. App. 1988). In *Childs*, an auto accident occurred injuring several people. *Childs*, 15 S.W.3d at 188. The insurance company settled some of the claims exhausting the policy limits without settling with one of the claimants. *Id.* Relying on a previous Texas Supreme Court case, the court stated that “[w]hen faced with a settlement demand arising out of multiple claims and inadequate proceeds, an insurer may enter into a reasonable settlement with one of the several claimants even though such settlement exhausts or diminishes the proceeds available to satisfy other claims.” *Id.* at 189 (citing *Texas Farmers Ins. Co. v. Soriano*, 881 S.W.2d 312, 315 (Tex. 1994)). The court held that it acted reasonably in exhausting the policy limits, and that because the limits were exhausted, the insurance company obligation to defend ceased. *Id.* The court stated that policy reasons support this approach because it promotes the settlement of lawsuits and encourages claimants to make their claims quickly. *Id.* Furthermore, the court stated that the policy language was clear that the parties’ intended to limit the duty to defend to the time before the policy limits were exhausted. *Id.* This decision comports with an earlier Texas case where

the driver hit another car killing the owner-passenger in his car and injuring the occupants of the other car. *Arnold*, 930 S.W. 2d at 198 (Tex. App. 1996). The insurance company settled with the estate of the owner for the policy limits and refused to defend the driver in the suits by the injured people from the other car. *Id.* at 199. The court held that the insurer's defense obligation terminated when the policy limits were exhausted. *Id.* at 201.

Pennsylvania and Louisiana courts have each ruled the same way when additional claims were asserted after one claim was settled exhausting the policy limits. *See Maguire v. Ohio Casualty Ins. Co.*, 602 A.2d 893 412 Pa. Super. 59; (Pa. Super. 1992); *Pareti v. Sentry Indemnity Co.*, 536 So.2d 417 (La. 1988). In *Maguire*, the trial court stated that the phrase in question is "as unambiguous in its meaning and intent as any string of Anglo-Saxon words in our experience has proven to be." *Maguire*, 602 A.2d at 894. The court held that the duty to defend terminated upon the exhaustion of the policy limits subject to the requirement that the insurance company act in good faith. *Id.* at 895.

Even in these jurisdictions that have held that the phrase "has been exhausted" is clear and only susceptible to one reasonable interpretation, the insurer is still subject to the requirement that they act in good faith. *See Smith v. Audubon Insurance Co.*, 679 So. 2d 372, 376 (La. 1996); *Maguire v. Ohio Casualty Ins. Co.*, 602 A.2d 893 412 Pa. Super. 59; (Pa. Super. 1992); *Viking Ins. Co. v. Hill*, 787 P.2d 1385, 1390, 57 Wn. App. 341, 350 (1990). The facts and circumstances of each case determine whether an insurer acted in good faith. *Smith*, 679 So. 2d at 376 (La. 1996). The factors that a court will examine include "the probability of the insured's liability, the extent of the damages incurred by the claimant, the amount of the policy limits, the adequacy of the insurer's investigation and the openness of communications between the insurer and insured..." *Id.* Insurers cannot require the insured to bear the burden of a full investigation

from the beginning or abandon its defense of a claim in the middle of a suit under circumstances that are prejudicial to the insured. *See McCarthy*, 8 A.2d at 752.

Conclusion

Even with revisions in the standard insurance policy, courts are still reluctant to allow insurers to tender their policy limits and terminate their duty to defend. While it is unclear whether all jurisdictions will allow insurers to include express policy language giving them the option to pay their policy limits and terminate their duty to defend, it is clear that absent express language giving the insurer the option to pay into the court that courts in most cases will require a release or judgment. This issue will probably be the source of increased litigation in the future as insurers continue to attempt to limit their duty to defend. When multiple claims arise under a policy, courts are more likely to allow the insurer to terminate its duty to defend. It is important to remember that under either of these situations that courts will look at the facts and circumstances of each case to ensure that insurers are acting in good faith.