

The Verses of a Professional Liability Policy

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Insurance policies covering professional liability risks commonly afford coverage with eroding limits - such that the insurer's payment of legal fees and expenses reduces the policy limits available to pay a settlement or judgment - and require an insured's consent to settle. These policies differ significantly from traditional, occurrence-based liability policies where fees and expenses incurred by the insurer in defense of the insured are outside of the limits of liability and claims can be settled by the insurer without the insured's consent. See *N. Am. Specialty Ins. Co. v. Royal Surplus Lines Ins. Co.*, 541 F.3d 552, 559 (5th Cir. 2008) (explaining eroding policies). Because "defense within limits" (hereinafter, "DWL"), (these policies are sometimes referred to as "burning", "wasting", "cannibalizing," or "self-consuming" policies), professional liability policies are subject to diminishing limits of liability and the insured's consent, unique considerations and risks arise when defending, evaluating, and settling third-party claims. An insured's knowledge of these provisions, along with extensive communication and understanding of defense tactics and decisions, will encourage a constructive tripartite relationship. As Benjamin Franklin advised long ago, "[a]n ounce of prevention is worth a pound of cure."

We Didn't Start the Fire, It Was Always "Burning" Limits

Insurers typically underwrite policies for professional liability risks on a "claims made" basis with DWL provisions to better anticipate risks and control premium costs. See 3 John E. Heintz, et al., *New Appleman Law of Liability Insurance*, § 24.04 (2022) ("Claims-made professional liability policies ordinarily specify that an insurer's duty to pay defense costs is 'within limits,' meaning that each dollar paid toward defense erodes the available coverage limits on the policy and leaves less for any eventual settlement or judgment."); Ronald M. Sandgrund, et al., *Colorado Construction Law* § 14.12 (2013) ("Licensed professionals such as architects, engineers, and real estate brokers often carry errors and omissions coverage, usually written on a 'claims made' rather than 'occurrence' basis. ...Some of these policies contain 'self-depleting' or eroding liability limits that decrease pro tanto as defense costs accrue."). Though the enforceability of DWL provisions have been challenged on public policy grounds, courts generally uphold DWL terms when they are unambiguous. These policies are often written for sophisticated insureds facing substantial risk, but when the existence of negligence may not be immediately discoverable. Gregory S. Munroe, *Defense Within Limits: The Conflicts of "Wasting" or "Cannibalizing" Insurance Policies*, 62 Mont. L. Rev. 131, 169 (2001) ("It appears that DWL policies have their place in high-risk coverages such as large commercial insureds, professional liability, and environmental liability."). Knowledge and communication of the nature of a DWL policy to the insured, defense counsel, and plaintiff's counsel are critical

to ensuring a successful defense of an insured, avoiding conflicts of interest, and preventing insurer bad faith.

When an insurer is defending an insured under a DWL policy, communication remains essential to protecting the insured's interests. An insured - and defense counsel - should be immediately informed of the DWL provisions and their practical effect: the policy's limits will begin to erode as soon as a claim is made and defense counsel is retained. When considering defense strategies and litigation decisions, both the insurer and defense counsel should err on the side of being overly communicative, particularly in the discovery phase. For example, extensive factual investigation, depositions of non-local witnesses, expert discovery, and motion practice can quickly erode limits. Both the insured and insurer should be informed of the practical and financial impact of pursuing or foregoing certain discovery or motions before reaching a decision to ensure they are in agreement with strategic defense decisions before defense counsel incurs significant fees and costs.

Providing evaluations, litigation plans, and itemized phased budgeting at an early stage and regular intervals - to both the insured and the insurer - increases the likelihood of informed and united decision-making. Failing to ensure all decisionmakers agree with the litigation strategy and attendant costs could lead to a conflict of interest. The insurer, for example, may prefer pursuit of an aggressive and expensive defense, whereas the insured may reject costly defense tactics to increase the limits available for settlement. As detailed below, consequential strategic decisions can become more complicated when the insured has the right to consent to any settlement.

Relatedly, as defense fees and expenses reduce limits, the insurer should be on guard of the potential for a verdict exceeding available policy limits. The insured should receive verdict ranges and estimated chances of a success at trial, especially when modified as a result of new information. When every dollar incurred in the insured's defense directly reduces the amount of available protection for the insured, the insurer should regularly notify the insured of defense costs incurred to date and the remaining limits. It may also be prudent for the insurer to notify the insured of the option to retain personal counsel at the insured's own expense, monitor the insured's defense, and consult as to defense decisions and settlement potential.

The ramifications of a DWL policy may also warrant early disclosure to plaintiff's counsel, particularly with an eye toward settlement discussions. When faced with a DWL policy, plaintiffs have an incentive to avoid lengthy litigation, and in turn, exhausting limited resources. See 12 Amy B Briggs and Susan P. White, *New Appleman on Insurance Law Library Edition* § 148.03 (2022) ("Strategically, a 'wasting' or 'self-depleting' policy may trigger an earlier settlement discussion in order to preserve payments for covered damages instead of allocating those funds to defense or other legal costs and reducing the amount available for damages."). While many jurisdictions mandate disclosure of a liability policy's terms to a plaintiff in litigation, strategic consideration should be given as to whether and when the full policy should be

produced, particularly if the claim has potential for excess exposure to the insured. DWL policies may present a circumstance where it is in the best interest of the insured, the insurer, and the plaintiff to settle quickly.

If early resolution is not an option, defense counsel should be cautious while engaging in settlement discussions during the course of complex or contentious litigation when it can be difficult for both plaintiff's counsel and defense counsel to determine the specific amount of remaining limits. Complications may also arise when defense counsel engages in settlement discussions with a sum certain, especially if opposing counsel relies on a representation of available limits to make a settlement demand which could be subject to change if not immediately accepted. Alternatively, defense counsel could consider offering the remaining limits, after accounting for all defense costs and fees, rather than making a representation on the exact amount available. Clarifying when and how the remaining limits will be calculated for settlement purposes is crucial to avoiding misrepresentations in negotiations or exposing the insured to a settlement above the available limits.

In sum, defense counsel should be aware of, carefully consider, and notify the insured of the impact a DWL policy has on all stages of case evaluation, litigation, and settlement.

Is It "Hammer" Time? The Insured's Right to Consent to Settle

Professional liability policies typically afford the insured the right to consent to any settlement, with the insurer agreeing not to settle any claim or suit without the written consent of the insured. Like the DWL provisions of a policy, the insured's right to consent to a settlement requires close attention. The consent provision takes into account an insured's interest in its professional reputation and the impact settlement may have on it, as well as the professional's ability to obtain affordable insurance.

If someone other than the named insured is being defended in a suit, take special note of who holds the right to consent. Often, the "named insured" - and not another insured, such as an employee or additional insured - retains an exclusive right to consent. Defense counsel should be attuned to any potential disagreement between the named insured and another insured regarding if and when to settle before a conflict arises. Notably, even if the named insured with the right to consent is not named in the suit, the named insured must nonetheless consent to any settlement unless the right to consent is delegable. To make an informed decision, the named insured should be kept apprised of material aspects of the case. Defense counsel, though, should exercise caution to ensure protection of the attorney-client privilege with the insured being defended. As a best practice, consent to settle should be memorialized in writing and specific to the settlement negotiations, as opposed to a blanket consent. Perhaps obvious, counsel should obtain consent from the insured before agreeing to a settlement.

An insured's right to consent to settlement is not without qualification. Many

professional liability policies include a so-called “hammer clause.” A typical consent to settlement provision with a hammer clause reads:

The insurer shall not settle any claim without the consent of the insured. If, however, the insured shall refuse to consent to any settlement recommended by the insurer and shall elect to contest the claim or continue any legal proceedings in connection with such claim, then the insurer’s liability for the claim shall not exceed the amount for which the claim could have been settled plus claims expenses incurred up to the date of such refusal.

Rawan v. Cont’l Cas. Co., 483 Mass. 654, 656 n.2, 136 N.E.3d 327 (2019). Application of the hammer clause imposes responsibility on the insured for all attorneys’ fees and indemnity payment in excess of the amount for which the matter could have been settled. A hammer clause effectively transfers the risk of a rejected but recommended settlement offer to the insured. The practical impact of the hammer clause is to apply pressure on the insured’s right to refuse consent to a settlement and increase an insurer’s chance of obtaining a settlement. *See id.*

To avoid delay in effectuating settlement or disagreement between the insurer and insured, an insured should be routinely informed of material developments in litigation and the risks (including economic consequences) of foregoing settlement. Communication and consultation with the insured in preparation for settlement discussions, thus, is essential to a defense under a professional liability policy.

The “Final Countdown”

Defense counsel, the insured, and the insurer should be aware of provisions common to professional liability insurance policies, such as “burning” limits and the “hammer” clause. These provisions require extra attention and consideration to ensure a successful resolution of the case.



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