The Legal Intelligencer
THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2017
PHILADELPHIA, THURSDAY, APRIL 13, 2017
An ALM Publication

INSURANCE LAW

# Exhaustion of Policy Limits and Termination of the Duty to Defend

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Liability insurance policies generally provide both indemnification against loss and defense against claims and suits. The cost of defense is generally paid in addition to the policy limits for indemnity. The defense is thus an important feature of the policy. In fact, liability insurance is sometimes characterized as both indemnity and litigation insurance.

The insurer's duty to defend is not without limits. The defense obligation is linked to the indemnity obligation in that the defense extends only to claims for which the insurer must indemnify the insured. Accordingly, policies generally stipulate that the insurer's duty to defend ends when it has used up the policy limits in payment of judgments and/or settlements. Further, the policy gives the insurer the discretion to settle any claim against the insured and the insured's consent to settle is not required.

The limitation on the duty to defend can create tension between the interests of the insurer and insured or between the interests of a primary insurer and an excess insurer when a claim is valued in excess of the limits. In that circumstance, an insurer may seek to terminate its duty to defend by exhausting its policy limits, leaving the insured or excess insurer (if such coverage is available) to assume the defense. This conflict of interests is particularly acute where the limits are low, as it is more likely that the cost of defense will exceed the liability limits, making it financially advantageous for the insurer to pay the limits as opposed to defending. This raises the question of limitations on an insurer's ability to terminate the defense where the policy limits have been exhausted.

Under Pennsylvania law insurance policy language stating that the duty to defend ends when the insurer has exhausted the policy limits is deemed to be clear, unambiguous and enforceable, as in Maguire v. Ohio Casualty Insurance, 602 A.2d 893 (Pa.Super. 1991), petition for allowance of appeal denied, 532 Pa. 656, 615 A.2d 1312 (1992); and in ACandS v. Aetna Casualty & Surety, 764 F.2d 968, 975 (3d Cir. 1985).

Most policies state that the duty to defend ends only when the limits are exhausted in payment of judgments or settlements. This has been held to mean that an insurer cannot terminate

its defense obligation by simply tendering its policy limits or interpleading the fund, as in Maguire, citing, Pareti v. Sentry Indemnity, 536 So. 2d 417, 424 (La. 1988). For instance, in Firemen's Insurance v. Ketner, 13 Pa. D. & C.3d 223, 228 (C.P. 1979), the primary insurer paid its $250,000 policy limits to the plaintiffs in return for a receipt from the plaintiff acknowledging that the plaintiff would credit the payment against any judgment obtained against the insured. The primary insurer then tendered the insured's defense to an excess insurer. The court held that mere payment to the plaintiff on account of the insured's ultimate liability did not terminate the primary insurer's obligation. The payment was not payment of a settlement because it did not end the litigation (see Charter Oak Insurance v. Maglio Fresh Food, 45 F. Supp. 3d 461, 473 (E.D. Pa. 2014) (primary insurer's payment of limits into escrow did not trigger excess insurer's obligation as payment was not for covered claim and did not exhaust primary limit)).

The insurer's duty of good faith and fair dealing toward the insured also imposes constraints on an insurer's ability to terminate its defense obligation via exhaustion of policy limits. This duty prevents an insurer from entering into a "dubious" release in order to quickly exhaust the limit of liability in order to avoid its duty to defend, as in NIA Learning Center v. Empire Fire & Marine Insurance, No. 05-5178, 2009 U.S. Dist. LEXIS 92991, at *2 (E.D. Pa. Oct. 1, 2009). In Maguire, the insured was involved in an auto accident resulting in the death of another driver. The insurer settled the decedent's estate's claim pre-suit for the $100,000 policy limit. Later, the estate sued two bars that had allegedly served the insured alcohol prior to the accident. The bars joined the insured as an additional defendant and the insured sought a defense from the insurer which denied the defense on the basis of policy exhaustion. The Superior Court found the insurer had acted properly noting that it had finalized the estate's settlement before the estate had sued the bars; it had obtained a release from the estate in favor of the insured and that it did not abandon the insured "mid-course" of litigation.

Thus, where multiple claims are asserted against the insured, an insurer that exhausts the policy limit in settling some, but not all, of the claims has no obligation to defend a subsequent claim, so long as the settlement that exhausted the limits was reasonable. This is so even where the insurer knows or has reason to know that additional claims will be asserted, as in National Specialty Insurance v. Advanced Cargo Transportation, No. 3:14-CV-001417, 2015 U.S. Dist. LEXIS 97896, at *18 (M.D. Pa. July 28, 2015), (insurer settlement of first asserted claim for policy limits was not bad faith). Thus, while exhaustion of limits in settlement of fewer than all claims will not necessarily subject an insurer to liability, it appears clear that any exhaustion of limits that does not protect the insured from any claims will not terminate the defense obligation, see e.g. Pareti v. Sentry Indemnity, 536 So. 2d 417, 422-23 (La. 1988); Brown v. Lumbermens Mutual Casualty, 326 N.C. 387, 394, 390 S.E.2d 150, 154 (1990).

One exhaustion issue for which Pennsylvania cases provide little guidance involves the relationship between primary and excess insurers. An excess insurer has no duty to defend unless/until the primary limits of coverage have been exhausted. Primary insurers will sometimes negotiate a deal in which the primary insurer pays its policy limits to the plaintiff in return for the plaintiff's agreement that he or she will not execute the insured's assets. The plaintiff does not release his claims against the insured, but instead agrees that he will satisfy any judgment only against the proceeds of the excess insurance. This situation raises the question of whether the primary insurer has exhausted the policy limits thus terminating the duty to defend. Courts in other states have held that such an arrangement constitutes an exhaustion of primary limits terminating the duty to defend, see e.g., United States Fire Insurance v. Zurich Insurance, 329 Ill. App. 3d 987, 993, 263 Ill. Dec. 528, 532, 768 N.E.2d 288, 292 (2002); California Casualty Insurance v. State Farm Mutual Automobile Insurance, 185 Ariz. 165, 913 P.2d 505 (1996). These courts found that payment of policy limits in exchange for a covenant not to execute against the insured is the functional equivalent of a settlement in that it fully protects the insured's interests.

In conclusion, it is important in these cases to remember that the insurer has an obligation to defend, but even that obligation has its limitations. •

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