"BURN, BABY, BURN":

THE ROLE OF "DEFENSE WITHIN LIMITS" LIABILITY POLICIES IN CONSTRUCTION DEFECT LITIGATION

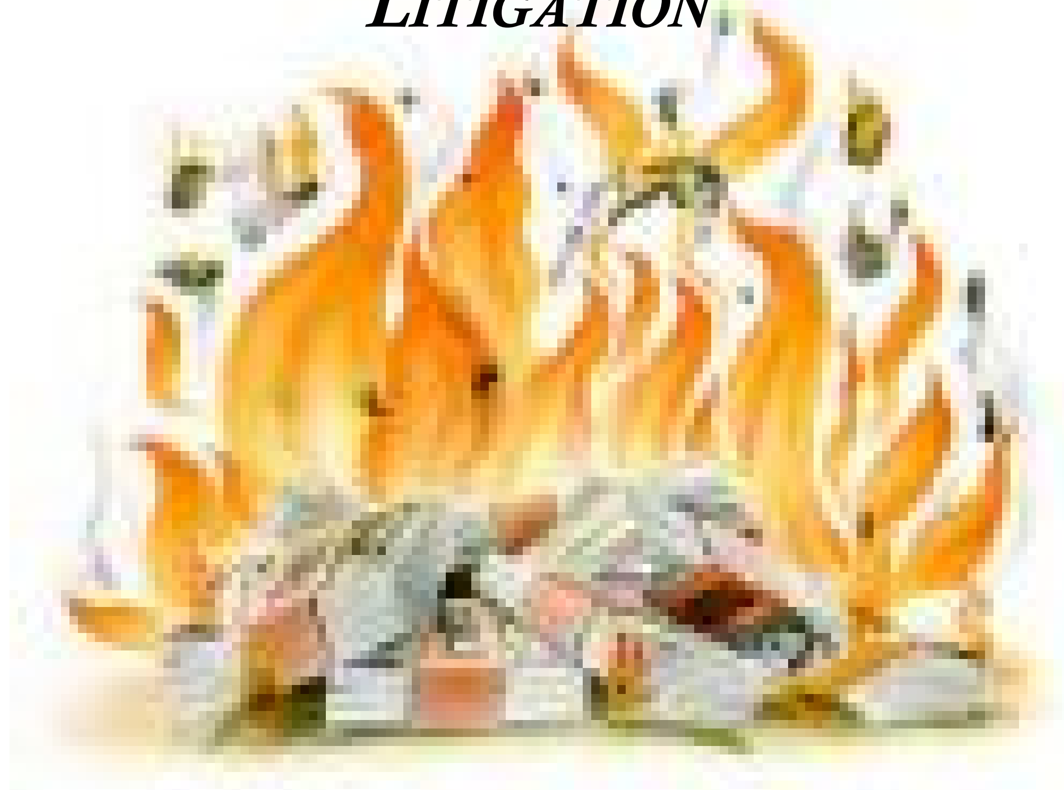

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TABLE OF CONTENTS

"Burn, Baby, Burn":

The Role of "Defense within Limits" Liability Policies in Construction Defect Litigation

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I. Introduction

A. Standard v. "Burning Limits" Policies

Most construction defect practitioners are thoroughly knowledgeable about the defense and indemnity obligations of standard liability insurance policies. These policies provide that insurers have a duty to defend the claim being asserted against the insured and a duty to indemnify the insured for resolution of the claim.[1] Standard liability insurance policies have indemnity limits, but not defense costs limits.[2]

Many construction defect professionals, however, are unaware of the additional obligations imposed by "burning limits" liability policies. Alternatively referred to as a "depleting," "defense within limits," "cannibalizing," "self-liquidating," "wasting," or "self-consuming" policies, these types of insurance agreements include provisions that limit the amount insurers will pay for defense of a claim.[3] The effect of a burning limits policy is straightforward – every dollar spent on defense correspondingly reduces dollars available to settle or otherwise resolve the claim. It is adherence to the additional duties created by burning limits policies that can present difficulties.

In years past, burning limits policies were mostly issued to guard against the liability of professionals, corporate directors and officers, and employers.[4] But of late, such policies have become increasingly available in the commercial general liability market. The availability of burning limits policies to CGL insureds is due, at least in part, to the widespread growth of construction defect claims. Expensive defense costs have driven more and more insurers to seek ways to limit exposure, but maintain a client base. Consequently, those construction defect professionals who have not already dealt with burning limits policies are sure to do so in the future.

This article's purpose is to familiarize those in the construction defect industry with the unique obligations of burning limits policies. These policies often present practical and ethical dilemmas for both plaintiffs' attorneys and defense counsel because every dollar spent on the defense reduces the amount available to satisfy potential judgments.[5] On the plaintiffs' side, the client's ultimate recovery, and the attorney's fee, is directly tied to handling of the case before trial.[6] The more money is spent on discovery, the less money is available for settlement.[7] On the defense side, counsel is often faced with a conflict of interest when the insurer attempts to control the defense.[8] Burning limits defense counsel may torn between proving their client not liable and protecting their client from personal liability.

In the following pages, we will discuss what a burning limits policy is, common burning limits policy language, and the history of the policies. We will describe additional duties of counsel and insurers when a burning limits policy is applicable. Additionally, we will explain the effect of "burning limits" policies on defense contributions of on-risk carriers. Finally, we will address the topic of how to properly resolve a claim in which burning limits policies are applicable.

II. The Burning Limits Policy: What Is It?

A burning limits policy is one that includes all defense costs and litigation expenses within the applicable limits of liability.[9] For each dollar spent on defense, one dollar is removed from policy funds available to settle or satisfy a judgment in the case.[10]

The following example demonstrates how burning limits policies function.[11]

How A Burning Limits Policy Works:

- Insured purchased liability policy with a $1,000 deductible and $100,000 limits
- Insured gets sued and defense counsel incurs $20,000 to take the necessary depositions and set the case up for settlement
- Plaintiff demands $95,000, which we will pretend is a great offer that should be accepted
- With an unlimited defense cost policy, the insurer would pay $95,000, insured would pay $1,000, and the insurer would pay the $20,000 in defense costs
- NET $COST_1$: Insurer - $114,000; Insured - $1,000
- With a burning limits policy, attorney would collect $1,000 from insured and bill the insurer $19,000, insurer would pay $81,000, and insured would pay $14,000 more
- NET $COST_2$: Insurer - $100,000; Insured - $15,000

A. History of Burning Limits Policies

1. Professional Liability Policies

The burning limits policy is not new – it has been around for a while.[12] In the early 1970's, insurance professionals were faced with medical malpractice claims increasing in number and size.[13] They desired greater loss predictability, and therefore, crafted malpractice liability policies to include "allocated loss adjustment expenses" within liability limits.[14]

For the next decade, burning limits remained a unique characteristic of a handful of medical malpractice liability forms.[15] Then in the 1980's, legal malpractice claims greatly increased.[16] Soon, burning limits appeared in virtually all professional liability policies.[17] However, at that time, concern among the legal profession centered on the change from "occurrence" to "claims-made" policies.[18] The fact that burning limits provisions had been added to legal malpractice policies received scant attention.[19]

2. Directors' and Officers' Liability Policies

In 1982, the insurance industry was exposed to an eye-opening corporate survey pertaining to directors' and officers' liability claims.[20] The survey results showed that the average cost to resolve D&O claims was $1,340,000 per claim of which an average of $763,000 accounted for settlement or judgment and $577,000 for legal fees.[21] Also during this period, insurers began experiencing untenable situations in which they expended thousands of dollars in non-reimbursable defense costs to get a "victory" at trial.[22]

The realization that defense costs could approach or even exceed resolution costs, together with insurers' horror stories, prompted insurers to market D&O policies with unique characteristics.[23] First among them was that the policies generally did not provide for a duty to defend.[24] Under these policy provisions, it was up to the insured to pay for its defense and then seek reimbursement pursuant to the indemnification language of the policy.[25] Such reimbursement was counted as a "loss" subject to the policy's liability limits.[26] Second, D&O policies were technically indemnity, and not liability policies.[27] Generally, the insurer had no duty to pay a judgment until it had been paid by the insured and reimbursement was requested.[28] Finally, D&O policies had burning limits in as much as defense costs reduced the amount compensable for indemnity coverage.[29]

3. Commercial General Liability

In 1985, the Insurance Services Office, Inc. ("ISO"), the trade organization for the insurance industry, developed a CGL policy with burning limits.[30] The form was popular with insurers struggling with the enormous volume of mass toxic tort cases.[31] However, after a few years, insurers encountered strong opposition to burning limits policies from consumers, marketing intermediaries, and regulators.[32] Detractors of burning limits argued that the increased risk that insureds would be subject to personal liability made the policies ineffective. Egged on by small and big business, insurance regulators soon propagated law restricting or prohibiting burning limits provisions.[33] Eventually, ISO withdrew the form.[34]

Since the late 1980's, the appearance of burning limits in CGL policies has been on the rise. The growing presence of these policies can be characterized as the inevitable result of more and more litigation combined with skyrocketing claim values. The construction and insurance industries must brace themselves for the effect of more burning limits policies in future years. Preparation for the impact of burning limits policies on construction defect litigation starts with understanding the advantages and disadvantages of such policies.

B. Advantages and Disadvantages of Burning Limits Policies

1. Insurer's Perspective

To insurers, cost containment is a main advantage of burning limits policies.[35] In continuing loss cases, such as those involved in construction defect litigation, defense costs have increased dramatically in recent years.[36] Insurers have advocated burning limits policies as a mechanism for facilitating early settlement, and thereby, reduction of defense costs.[37] They also like that these policies can assist them in accurately limiting their risk of exposure.[38] Premiums can be scheduled with the advance knowledge of the maximum amounts they might be required to pay, irrespective of the occurrence or loss, intricacy of the claim, or difficulty of the defense.[39]

A key disadvantage of burning limits policies to insurers is the increased risk of bad faith claims.[40] Bad faith liability theories asserted against insurers could be: (1) wrongful inflation of legal fees to prematurely reach aggregate limits; (2) misrepresentation of coverage by failing to provide notice that burning limits policies may create coverage gaps between primary and excess policies (e.g., excess policies are usually written to provide coverage only when primary policy limits are exhausted by the payment of judgments and settlements); and (3) failure to settle within policy limits when given a reasonable opportunity.[41] A successful bad faith claim usually opens up the policy, and therefore, burning limits policies may actually increase, and not decrease, insurers' overall liability.[42]

Burning limits policies might also be disadvantageous to the insurer because they could decrease marketability of their policies.[43] In the construction industry, certificates of insurance are employed as a convenient means to communicate financial responsibility of the insured to a third party.[44] Certificates state the name and address of the insurer, the types of policies held by the insured, and the coverage and liability limits of each policy.[45] They do not usually indicate whether a given policy has burning limits, or for that matter, how much of the limits remain for payment of future claims.[46] A conventional certificate of insurance may give the false impression that greater limits are available to satisfy a judgment than actually exist.[47] This misimpression could spawn litigation between the insured, insurer, and third parties.[48]

An additional disadvantage of burning limits policies is evident when defense costs exhaust policy limits in the middle of the litigation.[49] If the insured desires to hire a new attorney, the insurer is faced with the additional cost of educating new defense counsel and facilitating the substitution in the matter.[50]

2. Insured's Perspective

Many insureds embrace burning limits policies because of their reduced cost.[51] For the same liability limit, burning limits policy premiums are often priced 20% less than standard policies.[52] Some insureds do not mind "rolling the dice" and risking that defense and indemnity costs for future claims will not exceed policy limits.[53]

The disadvantage of a burning limits policy becomes clear when projected defense costs and potential exposure exceed policy limits.[54] Every dollar spent on defense reduces that available for settlement or judgment, and therefore, the insured often becomes torn between pursuing a vigorous defense and maximizing indemnity dollars available to avoid personal liability.[55]

Tips for Selecting an Appropriate Burning Limits Policy

Insureds can do the following to assure purchase of a suitable burning limits policy:

- Select an Appropriate Policy Limit: If you get sued and have a $100,000 limit, you may as well mail these funds directly to plaintiff's counsel if he has a halfway decent case. You cannot afford to decrease policy funds with defense costs. At a bare minimum, the smallest of cases take $25,000 to try. Therefore, you should consider no less than $250,000 limits if you want a burning limits policy.
- Pick a Proper Deductible: The higher the deductible, the cheaper the policy is. Realistically evaluate the possibility of being sued twice in the same year and how much you could afford to pay in defense costs for both cases. Make your deductible whatever that number is and purchase as much coverage thereafter as you can afford.
- Ask About Defense Allowances: Some insurance companies offer hybrid burning limits policies, which carry a defense cost allowance, such as $50,000, per policy year. Obtaining a policy with a defense allowance is a good way to keep premium costs down and liability limits available.[56]

3. Excess Carrier's Perspective

Almost nothing is desirable about a burning limits policy to a secondary carrier.[57] Most excess policy forms are not written to follow the form of a primary burning limits policy.[58] Expenditure of defense costs accelerates exhaustion of the primary insurer's liability limit.[59] Upon exhaustion, excess carriers are faced with the decision to litigate with the primary carrier or accept coverage. Accepting coverage is often difficult to swallow because many excess policies do not provide for a duty to defend. If this is the case and the insured has insufficient funds to pay for his own defense, the excess insurer must evaluate whether it should volunteer counsel to reduce exposure. The likely alternative is to pay a hefty judgment.

C. Common Burning Limits Policy Variances

1. When Defense Costs Count Against Liability Limits

Most burning limits policies do not distinguish between costs of defense and costs of settlement or judgment when calculating the amount charged against the policy limit.[60] Policies differ, however, concerning the ***time*** when defense costs count against policy limits.[61] Usually, policies can be categorized as having either Immediate Erosion or Preset Allowance Inception.[62]

a) Immediate Erosion

An immediate erosion burning limits policy provides that defense costs begin to erode indemnity limits when the first dollar is spent on defense.

b) Preset Allowance Inception

A preset allowance inception burning limits policy provides that defense costs are not charged against indemnity limits until after exhaustion of the insured's deductible and/or preset expense allowance. An example of a preset allowance inception policy appears in *Lipton v. Sup. Ct.*, 48 Cal. App. 4th 1599, 1606 (Cal. Ct. App. 2d 1996). The policy at issue in that case had a burning limits provision whereby the payment of defense costs would reduce the available limits for each claim after exhaustion of a $50,000 claim expense allowance.[63]

2. Existence of Burning Limits

It is important to some insurers to clearly state their policies contain burning limits. Others insurers require their insureds to read a little to discover the burning limits surprise. Two methods for creation of burning limits are popular.

a) Burning Limits by Express Declaration

Often in expressly worded policies, insurers disclose burning limits on the declarations page. An example of burning limits language is: "NOTICE: THE LIMIT OF LIABILITY AVAILABLE TO PAY JUDGMENTS AND SETTLEMENTS SHALL BE REDUCED BY AMOUNTS INCURRED FOR LEGAL DEFENSE. FURTHER NOTE THAT AMOUNTS INCURRED FOR LEGAL DEFENSE SHALL BE APPLIED AGAINST THE RETENTION AMOUNT."[64] After this declaration, the following language is usually inserted in a "Defense, Settlement" section included within the policy body: "It is further agreed that . . . the Company shall not be obligated to pay any Claim, judgment, or Claim Expenses or to defend or continue to defend any Claim after the applicable limit of the Company's liability has been exhausted by payment of judgments, settlements, or Claim Expenses."[65]

b) Burning Limits by "Loss" Definition

Insurers who prefer not to advertise their policies' burning limits chose to define the "loss" they cover as including defense expenses. However, rarely do they make the inclusion explicit. Usually, confirming a given policy has burning limits requires review of multiple sections and endorsements throughout the agreement.

An example of this method for defining a "loss" appears in *Helfand v. Nat'l Union Fire Ins. Co.*, 10 Cal. App. 4th 869, 880-81 (Cal. Ct. App. 1st 1992). Appellant in this case was National Union. The company issued three years of directors and officers' coverage for a large company called Technical Equities Corporation. Respondents and plaintiffs Leonard and Eileen Helfand were investors in securities offered by Technical. The securities became virtually worthless, and so the Helfands sued Technical for fraud. The verdict the Helfands obtained greatly exceeded National Union's $10 million per year policy limits.

Instead of handing over $30 million to plaintiffs, National Union argued that its D&O policies had burning limits, and therefore, the multi-millions it expended in defending Technical would be charged against the indemnity limits. The Helfands sued National Union for a declaration that the policies provided no defense cost limits. The trial court ruled in their favor and held that the policies were ambiguous and "a normal insured would not be aware of [their] 'self-consuming' nature."[66]

The Court of Appeal disagreed. It noted that its decision was against the backdrop that "D&O policies generally do not obligate the carrier to provide the insured with a defense."[67] It explained that, "[m]ore likely, they require the carrier to reimburse the insured for defense costs as an ingredient of the 'loss'[.]"[68] The Court then proceeded to analyze the applicable provisions of National Union's policies. First, it acknowledged that the policies provided coverage to directors and officers against a "loss" arising from claims made against the insureds. Second, it noted that the policies stated the insurer's liability would be limited to that shown at Item 3 of the Declarations, which provided a $10 million limit for each policy year. Finally, it reviewed endorsement number three of the National Union policies, which provided that when payment not exceeding the limit of liability had been made to dispose of a claim, costs, charges, and expenses and settlements would be payable up to the limit of liability. The Court of Appeal held that these provisions meant only one thing: "defense costs accrue against the policy's limit of liability."[69]

The court did acknowledge that the above-referenced provisions could have been written "simpler and clearer," but, read as a whole, they were not "legally ambiguous."[70] What the court failed to acknowledge, however, was that no valid purpose existed for communication of burning limits in such a complicated fashion. While law pertaining to contract interpretation provides "words of a contract are to be understood in their ordinary and popular sense,"[71] it also states that, in the case of uncertainty, contract language should be interpreted most strongly against the party who caused the uncertainty.[72] In this case, National Union's disjointed approach to defining a "loss" amounted to unavoidable uncertainty. Consequently, the ambiguity should have counted against National Union, and the Helfands should have prevailed.

D. When Burning Limits Policies Go Bad

1. Ambiguous Policy Language

One of the most heavily litigated questions concerning burning limits is whether the policy at issue has, in fact, burning limits. As is demonstrated in *Helfand*, some insurers do not expressly declare that their policies have burning limits. Therefore, courts are often called upon to examine policy language to determine the intent of the parties. A fair amount of case law has developed on this topic. The cases discussed below provide practitioners with guideposts for determining when a policy truly has burning limits.

a) *Okada v. MGIC Indem. Corp.*, 823 F. 2d 276 (9th 1987)

In *Okada*, assignees of shareholders of First Savings & Loan Association of Hawaii sued its directors and officers for mismanagement. Each director and officer retained defense counsel and sought payment from insurer MGIC Indemnity Corporation for attorney fees and costs incurred. MGIC agreed to pay the defense costs as they came due, but under a reservation of rights.

After two years of litigation, three of the directors and officers refused to accept payment of defense costs with the reservation of rights. MGIC discontinued payment of the defense costs. The three directors and officers filed an action against MGIC, seeking declaration that the carrier had an unfettered duty to pay their defense costs as incurred. At the time of the action, the defense costs exceeded MGIC's $1 million policy limit. The three directors and officers obtained summary judgment in their favor.

The Ninth Circuit affirmed the district court's ruling. As described below in the discussion of the *McCuen* case, the Court found that Clause d(1) of the MGIC policy imposed a duty on the insurer to pay the insureds' defense costs as incurred. It decided Clause 5(c), which permitted the carrier to advance defense costs or pay them upon resolution of the claim, was ambiguous and did not clearly abrogate the duty provided in Clause d(1). The Ninth Circuit acknowledged that ambiguities in insurance contracts were to be construed in favor of the insureds. Therefore, the Court held, the MGIC policy could not be read to allow the insurer to pay defense costs only at the time of the claim's resolution. This case begins the recurring sentiment that ambiguous burning limits language will not be upheld.

b) *Branning v. CNA Ins. Co.*, 729 F. Supp. 728 (W.D. Wash. 1989)

Plaintiffs in this matter were former officers and directors of Home Savings and Loan Association. They purchased a D&O policy from CNA / American Casualty Insurance Companies and were later sued by Home's shareholders for mismanagement. Plaintiffs sued CNA for a declaration that their policy did not have burning limits. The context of the decision was plaintiffs' motion for summary judgment filed with the district court.

To decide the matter, the Court first reviewed the applicable provisions of the CNA policy. The "Limits of Liability" section stated that the insurer would be liable for 100% of any "Loss" (including costs, charges, and expenses) in excess of the retention amount, but up to the limit of liability. The section provided further that the "Limit of Liability" was the maximum aggregate liability of the insurer with respect to claims made in each policy year. "Loss" was defined as any amount the directors and officers were legally obligated to pay for a claim made against them for wrongful acts and included but was not limited to, damages, judgments, settlements, costs, and defense of legal actions.

The district court acknowledged plaintiffs' argument that the above provisions distinguished between "losses" and "claims made." Plaintiffs' assertion was that, while "Loss" was defined to include defense costs, "claims" were not. It was "claims" and not "losses" that served to reduce the "Limit of Liability." Therefore, plaintiffs' argued, defense costs, as merely "losses," did not deplete CNA's liability limit.

The Court discussed CNA's countervailing argument, also. It was CNA's position that the "Limits of Liability" section was actually couched in terms of "losses." The policy provided that CNA would be liable for 100% of a "Loss," which was defined to include defense costs. Consequently, CNA concluded, burning limits were applicable.

To resolve the motion, the district court avoided a detailed adoption and/or rejection of various points of the parties. It noted that deciphering any relevant information concerning CNA's underlying intent about the nature of defense costs required review of three different clauses appearing on three different pages. It found that CNA's policy simultaneously used the separate terms "claims" and "losses." Finally, it saw no express statement that defense costs were included in the liability limit. These three factors led the Court to conclude that the policy was ambiguous with respect to the existence of burning limits. It held that the ambiguity should be construed in favor of the insured, and therefore, plaintiffs were entitled to partial summary adjudication on the issue of whether the policy terms were ambiguous. In dicta, the district court stated that an intention to create burning limits "must be clearly and unambiguously stated."

c) *McCuen v. American Cas. Co.*, 946 F. 2d 1401 (8th Cir. 1991)

The relevant issue in the *McCuen* case concerned ***when***, and not whether, the insurer was obligated to pay defense costs. Shareholders, who alleged violation of fiduciary duties and mismanagement, sued directors and officers of Capitol Savings. The directors and officers tendered the action to their primary carrier, American Casualty. The insurer denied coverage. The directors and officers sued for declaratory relief. The district court held that American Casualty was obligated to pay defense costs as they were incurred, but was not required to pay attorney fees and costs related to the declaratory relief action. Both American Casualty and the directors and officers appealed.

To determine when the policy required American Casualty to pay defense costs, the Eighth Circuit examined the relevant portions of the policy. American Casualty's form obligated it to pay all losses that the insureds became legally obligated to pay. The definition of "loss" included "damages, judgments, settlements, costs . . . and defense of legal actions[.]" The Court concluded that, in the absence of other modifying provisions, the policy would require American Casualty to pay the insureds' legal expenses as incurred. However, the carrier argued that Clause 5(c) of the policy changed the meaning of the earlier provisions. This clause provided that "[t]he Insurer may at its option and upon request, advance on behalf of the Directors and Officers, or any of them, expenses which they have incurred in connection with claims made against them, prior to disposition of such claims[.]" American Casualty asserted that, by virtue of Clause 5(c), it could advance defense costs either as incurred or at resolution of the claim.

The Eighth Circuit rejected the argument. It concluded that the definition of "loss" seemed to require the carrier to pay defense costs as incurred and trumped the Clause 5(c) modification. It characterized American Casualty's policy as "clearly" a liability policy and not an indemnity contract. Finally, the Court adopted the interpretations of the Third and Ninth Circuits when reviewing similarly worded provisions in other cases. Both these circuits found that: (1) Clause d(1) imposed a duty on the insurer to pay the insureds' defense costs as incurred; (2) Clause 5(c) was ambiguous and did not clearly abrogate that duty; and (3) courts were obligated to construe ambiguities in favor of the insureds. The conclusion from these findings was that the duty of the insurer to pay defense costs as incurred was applicable.

d) *International Ins. Co. v. Imperial Cas. & Indem. Co.*, 1992 WL 547721 (C.D. Cal. 1992)

International Ins. Co. involved two insurers of a Los Angeles architectural firm. Imperial was the firm's primary carrier and furnished a "claims made" professional liability policy with limits of $2 million per claim and in aggregate. The policy also had a $100,000 deductible per claim and a $500,000 aggregate deductible limitation for all claims. Premium on the Imperial policy was in excess of $200,000.

The architectural firm also had an $18 million per claim and in the aggregate excess policy with International. The excess policy had "following form" coverage.

Eleven claims were made against the architectural firm between the policy periods of October 1, 1984 and October 1, 1985. By August 1992, the architectural firm had paid its $500,000 aggregate deductible, and Imperial had paid $450,000 in settlements and $2,133,003.63 in defense costs. Imperial asserted that its primary policy had burning limits. It demanded that International pay the amounts it had paid in excess of its policy's $2 million limit. International rejected the demand.

A federal declaratory relief action by Imperial ensued. The parties each moved for summary judgment. The district court decided the motions by examining the language of the Imperial policy. Imperial acknowledged that it was obligated to pay all sums the insured became legally obligated to pay as "damages" arising from negligence, mistake, or omission. It pointed out that its policy defined "damages" to include loss, judgments, settlements, and "*costs, charges and expenses*." But the court found that the policy's discussion of the coverage obligation in terms of "damages" and liability limits in terms of "claims" militated against Imperial's argument that the policy had burning limits. It further found the $2 million limit applied only to "claims" and not damages. The court examined other portions of the policy and observed that "claim" appeared in the disjunctive with "costs, charges and expenses." This indicated that the authors of the policy viewed these terms as separate and distinct. Finally, the court found it significant that the architectural firm paid in excess of $700,000 for the primary coverage, including premium and deductible payments. It concluded, therefore, that it was "highly unlikely" that the firm's expectation was to pay 35% of the liability limits only to have coverage exhaust when Imperial paid $2 million in legal fees.

This case is significant because it demonstrates value of having clear burning limits policy language. To assure recognition of burning limits, insurers must not merely modify the coverage language of ISO forms. They must make sure that the entire policy clearly supports the burning limits provisions. The case is also significant for those representing insureds or other carriers on the risk who are confronted with the argument that they are liable for all defense costs because one carrier has burning limits. The first question that one in this situation should ask is: "Does this carrier truly have a burning limits policy?" In *International Ins. Co.*, the excess carrier was able to avoid payment of defense and indemnity costs by demonstrating that the single mention of "costs, charges and expenses" as being incorporated in "damages" was insufficient to make the policy have burning limits.

e) *Bankers Trust Co. v. Old Republic Ins. Co.*, 7 F. 3d 93 (7th Cir. 1993)

Bankers Trust obtained a $12.88 million judgment against Keeling & Associates. It sued Keeling's excess carriers for payment of the judgment. Imperial Casualty and Indemnity Company, Keeling's primary carrier, intervened in the action and sought a declaration that its coverage was exhausted. Specifically, Imperial argued that its policy had burning limits and defense legal expenses amounted to more than the $2 million liability limit. The district court found against Imperial.

The Seventh Circuit affirmed. To arrive at its decision, the Court analyzed the relevant portions of Imperial's policy. Section one obligated the insurer to pay all sums the insured was obligated to pay as "damages" by reason of liability arising out of a negligent act, error, mistake, or omission in rendering or failing to render services. Section four was entitled, "Limits of Liability," and provided that Imperial's liability per claim would not exceed the amount stated in the declarations. The declarations section stated that the carrier's liability for each claim was $2 million. It further provided that "[t]he limit of liability afforded under the Policy shall be subject to the deductible amount (set forth below) which shall be applicable to 'each claim' and shall be inclusive of 'costs, charges, and expenses'." "Costs, charges, and expenses" were defined to include legal expenses. The definition of "damages" included loss, judgments, settlements, and "costs, charges, and expenses."

Imperial's argument was that it was required to pay only "damages," and the policy defined "damages" to include defense costs. Therefore, it concluded indemnity and defense costs exhausted the liability limit. The Seventh Circuit disagreed with the contention, however. It found no express mention that defense costs eroded liability limits. It pointed to section four of the policy, which stated that Imperial was not obligated to pay any claim or judgment or defend after the applicable limit of liability was exhausted by payment ***of judgment or settlements***. The court decided Imperial's failure to provide that payment of defense costs up to liability limits extinguished its obligations was indicative of its intention to avoid creation of a burning limits policy. Additionally, the Seventh Circuit found that the policy provisions could be plainly understood to create no defense cost limits.

f) *Weber v. Indemnity Ins. Co.*, 345 F. Supp. 2d 1139 (D. Haw. 2004)

Weber is an important case because it sets forth the rule that "if an insurer wants a liability policy to be a DWL or cannibalizing policy, it needs to say so specifically." The insurer needs to define the limits (e.g., covered "expenses" or "losses" or "damages") as including costs and fees to defend the underlying claim or suit[.]" This decision provides a bright-line rule for insurers seeking to have liability policies construed as having burning limits.[73]

E. The Final Analysis: Does a Policy Truly Have Burning Limits?

What practitioners can take from review of the above cases is that generally courts are hesitant to find burning limits when it is a questionable call. Synthesis of the courts' analyses indicates that courts often employ a multi-step approach to determining whether a given policy truly has burning limits. The first step in the approach is to review the entire policy, including endorsements, as a whole. The second step is to locate any express burning limits language in the policy. The third step is to identify relevant ambiguities in the provisions that prevent an easy decision one way or the other. The fourth step is to locate other court decisions that addressed similar ambiguities. If the rationale in these decisions is compelling, the analysis may stop there. If, however, no relevant decisions exist or the rationale of the ones that do is inconsequential, courts perform the fifth step in the analysis and give the insured the benefit of the doubt with respect to the identified ambiguities, i.e., construe ambiguities against the insurer. Often courts add to the analysis an examination of the complexity of the ambiguities. For example, an express declaration of burning limits with a later mention in an endorsement that "loss" does not include defense costs would probably be viewed as a minor ambiguity, which may not weigh in favor of the insured. However, when purported burning limits language is littered throughout the policy, endorsements, riders, and other attachments, courts are more likely to characterize the existence of burning limits as extremely ambiguous and rule in favor of the insured.

A lesson to be learned from the above cases is that insurers can virtually guarantee interpretation of their policies as having burning limits, if the burning limits language is express. The courts, discussed above, were quite hostile to language that seemed to hide the fact that defense costs decreased policy limits. Therefore, insurers who desire to only undertake the obligations of a burning limits policy must make that clear and express in the policies themselves.

III. Unique Obligations of Counsel and Insurers Created by Burning Limits Policies

A. Ethical Obligations of Attorneys

Defense attorneys who represent an insured with a burning limits policy may face unique ethical challenges. These issues can emerge at the time of retainer, during litigation and settlement discussions, and at the termination of the insurer's duty to defend.

1. Ethical Concerns at Retention

a) Plaintiff's Counsel

An attorney has a duty to keep the client reasonably well informed regarding the subject matter of the representation.[74] She must "respond promptly to reasonable status inquiries of clients" and keep clients reasonably informed of significant developments in matters with regard to which the attorney has agreed to provide legal services."[75]

Adherence to this obligation is doubly important when counsel represents a plaintiff who has sued a defendant with a burning limits policy.[76] Immediately upon first notice of defendant's burning limits policy, plaintiff's counsel must inform her client of the existence of the policy. Plaintiff and his attorney must weigh the value of every dollar defendants are compelled to spend on defense of the matter.[77] They must carefully discuss each and every potential impact the burning limits policy could have on the case.[78] Such discussions should be confirmed in writing as a means to protect counsel. Plaintiff's attorney should take every opportunity to cooperate with defense counsel in discovery to avoid wasting liability limits.[79]

Further, counsel should attempt to settle the case early to enhance the ultimate recovery.[80]

b) Defense Counsel

Representation of an insured with a burning limits policy is a difficult proposition.[81] On one hand, the attorney is obligated to attack the validity of the claim with all available resources.[82] On the other, counsel is obligated to protect the client from potential personal liability.[83]

Defense attorneys must decide for themselves the line between excessive advocacy and vigorous defense.[84] Apart from the client's potential excess exposure, defense counsel must determine whether or not an early settlement would actually encourage the filing of additional lawsuits.[85]

Further, burning limits defense counsel must be prepared to face the inherent conflict of interest arising from the fact that primary control over the available policy funds resides in the insurer.[86] Often, the insurer's interest is to spend policy limits on defense costs to defeat the claim and discourage future litigants. An insured may also want to fight the claim, but usually, not at the cost of having to pay for a judgment or settlement out of his own pocket. When a dispute arises between the insurer and insured about how to use the available policy funds, the defense lawyer ends up right in the middle.

No case law provides specific guidance on how to resolve the inherent conflict described above. When exposure beyond policy limits is likely, fairness probably requires the carrier to allow the insured to decide whether to defend a claim with available policy funds or attempt an early settlement.[87] To reduce bad faith liability exposure[88], the insurer should permit the insured to retain his choice of defense counsel and relinquish control of the defense to counsel the insured selects.[89] However, when no personal liability is probable, the insurer may retain its right to control the defense.[90] Either way, the insured must be properly advised of the ramifications of aggressive defense versus early settlement.[91]

Checklist:

Defense Ethical Obligations to Client with Burning Limits

- ☑ Advise client of liability exposure and potential value of the case;
- ☑ Explain to client impact of burning limits policy on defense strategy;
- ☑ Advise plaintiff's attorney of existence of burning limits policy;
- ☑ Early analysis of settlement options and begin settlement discussions;
- ☑ If an actual conflict of interest arises, recommend appointment of independent counsel for insured;
- ☑ If possibility of excess exposure exists, notify carrier and get client consent to defense strategy after disclosure of settlement options; and
- ☑ Advise client of any excess verdict potential and the need to give appropriate notice to excess carriers.

2. Dealing Ethically and Fairly with Insured When Policy Limits Are Exhausted

a) Defense Counsel

Akin to the situation in which an insurer denies coverage and "pulls the defense" after reserving its rights, there may come a time during the representation of a burning limits insured when policy funds become exhausted. The carrier should provide immediate notice that it will no longer pay for the defense. The attorney has two options: (1) withdraw from the representation of the insured; or (2) negotiate to have future defense costs paid directly by the insured. The following discusses the proper way to accomplish each of these two objectives.

(1) Withdrawal

Deciding to withdraw does not make the withdrawal complete. Defense counsel must obtain client consent or a court order to be removed from representation of the insured in a matter.[92] Additionally, until a duly executed substitution of counsel form is filed with the court or an order of withdrawal has been entered, the attorney remains obligated to act competently to protect the client's interests in the matter.[93]

After obtaining a legal withdrawal, the attorney must take "reasonable steps to avoid foreseeable prejudice" to the client's rights.[94] These steps include communicating upcoming dates and deadlines to the client, ensuring return of client files and papers, and cooperating with successor counsel.[95]

(2) Negotiate Direct Payment of Fees by Insured

If defense counsel is comfortable continuing to represent the insured after policy limits have been exhausted, she may want to negotiate a fee agreement directly with him.[96] Generally, a contract entered into between an attorney and her existing client is presumed to be made with undue influence.[97] However, in the case of negotiating fees for continuing legal services, this presumption does not take effect.[98] The fee agreement will be enforceable as long as it is "fair, reasonable and fully explained to the client."[99]

If the insured declines counsel's offer to continue representation with a direct fee arrangement and fails or refuses to sign a substitution of counsel form, the defense attorney must move for a court order of withdrawal. However, these motions are not always granted. In California, no express authority exists for the proposition that exhaustion of policy limits, by itself, is sufficient justification for an order of withdrawal.[100] Courts faced with such a motion will be required to review analogous authority. In 1981, the California State Bar Committee on Professional Responsibility and Conduct ("COPRAC") held that failure of a third party to pay an attorney's fees alone does not release the attorney from an obligation to continue to represent a client in litigation.[101] The Committee ruled that withdrawal might only be permitted when a circumstance enumerated in California Rule of Professional

Conduct 3-700 is applicable.[102] Therefore, counsel moving for withdrawal is advised to include in her argument grounds for withdrawal, in addition to, exhaustion of policy limits.

b) Burning Limits Carrier

Is the carrier jointly and severally liable for harm caused to the insured when the carrier terminates the defense due to exhaustion of policy limits and defense counsel fails to take reasonable steps to avoid prejudice to the insured? In other words, does the carrier owe the insured a duty after policy limits exhaustion to pay defense costs until a substitution of counsel has been filed or an order of withdrawal is entered? If the exhaustion is disputed, then the answer to these questions is, "Yes."[103] If it is undisputed that past defense costs have exhausted the policy, then the answer is, "We don't know."[104] While the California Supreme Court repeated, in a footnote, the general proposition that a burning limits carrier's contractual obligation to defend extinguishes upon policy limits exhaustion, it did not foreclose the possibility that an insurer's failure cooperate with the insured in its transition to new counsel could be the basis for a breach of contract or bad faith action.[105]

B. "Good Faith" Obligations of Burning Limits Insurers

Because of the reduced coverage available under burning limits policies, carriers of these policies owe their insureds "good faith" obligations in addition to those provided by standard liability policies. These duties are the following:

1. Duty to Keep Insured Informed about Defense Costs

Defense costs are expensive and add up quickly. Even after a couple of months of litigation, policy limits can be substantially depleted, and thus, unavailable for a settlement. Predictably, insureds will complain to the carrier that if they had known about the amount of the defense costs earlier, they would have requested defense counsel settle earlier. They will allege the insurer committed bad faith by failing to keep the insureds updated on pending defense costs. To avoid the specter of these claims, carriers and/or defense counsel should send copies of monthly billing statements to insureds.[106] Additionally, carriers should include a copy of a policy limits balance sheet, showing amounts spent on other claims and the amount of policy funds available.

2. Duty to Avoid Incurring "Unreasonable" Defense Costs

Because defense costs count against policy funds available to protect the insured's personal assets, insurers should be extra-careful in authorizing these expenditures. They must assume that if the policy exhausts before resolution of the litigation, the insured will review each and every billing statement and complain about defense costs he believes were unnecessary and/or unreasonable. To reduce bad faith liability exposure, insurers should give additional thought to what legal services are actually ***needed*** to protect the insured's interests.[107]

3. Duty to Settle as Early as Possible

When defense costs have been expended on the insured's behalf and it becomes apparent that the case cannot be settled within policy limits, the insurer is placed in a difficult situation. It is subject to bad faith liability for requesting the insured contribute to a settlement fund.[108] If it lets the case go to trial, substantial defense costs will be incurred, which will further reduce the available indemnity limit. If the jury renders a verdict for plaintiff in an amount above the remaining indemnity limit, the insurer will be confronted with some unhappy insureds. Inevitably, they will sue the insurer for bad faith or assign bad faith rights to the plaintiff with a covenant not to execute.

The prospect of the above scenario has led commentators to conclude that burning limits policies impose the additional obligation on insurers to settle the insureds' case as soon as possible once it becomes apparent that defense costs will erode the policy limit and make settlement within policy limits impossible.[109] At present, this additional "good faith" duty has not been established in California law. However, given precedent for determining whether an insurer acted "unreasonably" or "without proper cause," it seems clear that courts would consider an insurer's failure to settle when given a reasonable opportunity as a factor in determining whether bad faith was committed.

IV. Effect of Burning Limits Policies on Defense Contribution among Multiple Carriers on the Risk

A. Standard and Burning Limits Carriers with Joint Defense Obligations

Because construction defect actions generally involve alleged continuing losses, defendant insureds often have multiple carriers obligated to provide coverage for a given claim. Sometimes, one or more applicable policies have burning limits. This situation presents a bit of a quandary for the remaining carriers. They may ask, "How are defense costs allocated among the carriers?" or "What is the effect of the burning limits policies on insurers' indemnity contributions?" The following discusses appropriate methods for answering these questions.

1. Insurers Covering the Same Risk Share Defense Costs

The general rule is that when several insurers jointly share the same risk, each must share defense costs. Courts apportion defense costs on the basis of "equitable considerations which may arise, and which affect the insured and the . . . carriers, and which depend upon the particular policies of insurance, the nature of the claim made, and the relation of the insured to the insurers."[110] While joint insurers each have an independent duty to defend a claim in its entirety, they also have a right to compel other carriers to share in this duty and pay a portion of defense costs.[111]

a) Methods of Apportionment

Two methods of apportionment are commonly used to allocate equitable shares of defense costs.

(1) Equal Shares

Under the equal shares method of apportionment, the court adds up each carrier's highest policy limit, regardless of the years on the risk.[112] So, for example, if CNA had limits of $300,000 per year for five years, Pacific had limits of $300,000 per year for three years, INA had limits of $300,000 per year for four years, and Seaboard had limits of $100,000 per year for one year, the total of the policy limits would be $1,000,000. To employ equal shares methodology, the court divides each carrier's highest policy limit by the total policy limits and characterizes the results as percentages. In this example, CNA, Pacific, and INA are each responsible for 30% of defense costs and Seaboard is responsible for 10% of defense costs.[113]

(2) Time on the Risk

Time on the risk apportionment takes into account each carrier's years of coverage and policy limits. The first step in applying this methodology is to multiply the number of years of coverage of each policy by the per year limits in each policy.[114] Using the above example, CNA's total coverage limits would be $1,500,000, Pacific's total coverage limits would be $900,000, INA's total coverage limits would be $1,200,000, and Seaboard's total coverage limits would be $100,000. The second step for time on the risk apportionment is to divide each carrier's total coverage limits by the total coverage limits of all policies to get a percentage responsibility for defense costs. Adding up all coverage limits equals $3,700,000. Therefore, CNA is 41% responsible for defense costs, Pacific is 24% responsible for defense costs, INA is 32% responsible for defense costs, and Seaboard is 3% responsible for defense costs.[115]

b) Adding Burning Limits Into the Mix

The above examples demonstrate a fairly straightforward application of two methodologies employed to achieve equitable apportionment of defense costs among multiple carriers on the risk. A problem arises, however, when one or more of the applicable policies have burning limits. In situations such as these, using policy limits and/or time on the risk is not a true approximation of relative responsibility for defense costs. Carriers with burning limits have an additional liability to their insureds – they must incur only necessary and reasonable defense costs or face potential liability for all defense and indemnity costs on all applicable claims. Consequently, they will fight vigorously for an apportionment method that results in their payment of the smallest share of defense costs.

Needless to say, apportionment of joint defense responsibilities between standard and burning limits insurers can be difficult. The easiest way to resolve the problem is to conduct a meeting with all carriers on a given risk. Carriers should enter into a written agreement on how defense costs will be apportioned. The agreement might put in effect the equal share or time on the risk methodologies discussed above. It might allocate payment of certain defense costs to each carrier. For example, carriers with larger limits are responsible for day-to-day defense costs and carriers with lower limits available are responsible for mediation costs. The carriers might also agree to waive contribution of defense costs from the burning limits carriers to save amounts available on the burning limits policies for settlement or judgment. Any variants of the above could be implemented to avoid litigation among the joint carriers.

However, often litigation is necessary because a defense cost apportionment methodology cannot be agreed upon. Declaratory relief actions are available to resolve defense cost apportionment disputes among insurers of a given insured.[116]

(1) Additional Insurer Has Burning Limits Policy

To make things complicated, let us assume one of the insurers on the risk was an additional insurer, viz. a carrier owing a defense and indemnity obligation to two or more separate insureds involved in the litigation. If no indemnity agreement existed between the additional insured and named insured, the additional insurer would have the contribution obligation of every other primary carrier. Thus, apportionment of defense costs would be the only complexity. However, if the additional insured and named insured had an indemnity agreement, the additional insurer may have responsibility for all defense and indemnity costs for a given year(s) on the risk.[117] In a construction defect case, it may be difficult to accurately allocate defense and indemnity costs per year of the loss. But, the existence of the indemnity agreement may give other on-risk carriers of the additional insured ammunition to negotiate a higher contribution level from the additional insurer.

A conflict will inevitably arise, however, if the additional insurer has burning limits. Such insurer faces potential liability to both the named and additional insured for unreasonable defense expenditures. If excess liability is likely, the burning limits additional insurer will not be comfortable merely paying a percentage of defense costs. Percentage allocation is too inaccurate to protect against bad faith liability. Further, such allocation disallows the carrier from controlling specific defense costs. The burning limits additional insurer, therefore, is motivated to achieve certainty of its obligations by agreement or court declaration.

V. Settlement of Claims in Which Burning Limits Policies Are Applicable

Insurance policies generally allow the insurer to settle a claim when it deems appropriate. However, the insurer's ability to settle is impacted by the implied covenant of good faith and fair dealing. This covenant obligates the insurer to accept *reasonable* settlement demands within policy limits to avoid exposing the insured to personal liability in excess of those limits.[118] When a policy has burning limits, discharging this duty is even more important. The longer the case is litigated, the lower policy limits become and the greater the risk of an excess judgment.[119]

Therefore, the existence of burning limits has the effect of obligating burning limits insurers to settle a claim as early as possible. The following discusses the requirements of a bad faith failure to settle action and ways both standard and burning limits insurers can avoid liability.

A. Elements of a Bad Faith Failure to Settle Claim

The elements of an insured's bad faith failure to settle claim include: (1) insurer violated a failure or refusal to settle bad faith liability standard; (2) insurer had an opportunity to settle within policy limits; and (3) insured was damaged.[120]

B. Failure or Refusal to Settle Bad Faith Liability Standards

An insurer who fails or refuses to settle a claim against its insured may be found to have committed "bad faith" based on either of two theories: (1) "prudent insurer" standard; or (2) "act at own risk" standard.[121] Under the "prudent insurer" standard, an insurer is liable for bad faith if it acted "unreasonably" or "without proper cause" in failing to respond to or rejecting a settlement offer.[122] An insurer is liable for breaching the "act at own risk" standard if it rejects a reasonable settlement offer within policy limits on the basis that the policy does not cover the claim.[123]

C. Opportunity to Settle Within Policy Limits

For a failure or refusal to settle to have been in bad faith, the insurer must have had the ***opportunity*** to settle the claim within policy limits.[124] An opportunity to settle is shown by evidence that: (1) plaintiff made a reasonable offer to settle within policy limits; and (2) the insurer either rejected the offer or failed to accept it within the time provided for acceptance.[125]

1. "Reasonable" Offer to Settle

Generally, bad faith failure to settle cases involve a carrier's wrongful rejection of or failure to accept *plaintiff's* settlement offer. However, bad faith liability may also stem from defense counsel's failure to initiate settlement negotiations, regardless of whether the applicable policy has standard or burning limits. The following addresses potential bad faith claims in each of these contexts.

a) Plaintiff's Offer Is Not Accepted

A "reasonable" settlement offer from plaintiff must exhibit the following characteristics: (1) it must have clear terms; (2) all claimants must join in demand; (3) it must provide for release of all insureds; (4) amount demanded must be: (a) within policy limits and (b) "reasonable" in relation to damages and insured's likely liability for damages; and (5) the time for acceptance must afford the insurer adequate opportunity for investigation of the conduct of the insured, claimant, and damages claimed.

(1) "Reasonable" Amount of Demand

A settlement offer must be in a "reasonable" amount or the insurer does not face liability for failing to respond to it. Courts determine the reasonableness of a demand by considering all information known and available to the insurer at the time plaintiff made the offer and determining whether it is likely that a judgment will be returned against the insured in excess of policy limits.[126] Uncertainty with respect to the likelihood of the insured being subject to personal liability decreases the reasonableness of a policy limits demand.

(a) Burning Limits Policy's Effect on Reasonableness of Settlement Amount

With a burning limits policy, the longer the case is litigated, the lower the indemnity limits become. With the reduction of liability limits, the insured faces a greater risk of personal liability for judgment amounts above policy limits. This reality affects the reasonableness of the amount plaintiff demands for settlement. As a practical matter, the mere presence of a burning limits policy causes plaintiff's demand within policy limits to be much more "reasonable" than it otherwise would be if a standard liability policy were applicable. Further, the applicability of such a policy furnishes the insurer with a greater obligation to settle as early as possible.

b) Defense Fails to Initiate Settlement Negotiations

The existence of bad faith liability for failing to begin settlement talks is impacted by whether the policy at issue has standard or burning limits.

(1) Standard Liability Policies

California case law is not clear on the issue of whether a carrier, with a standard liability policy, can be liable for defense counsel's failure to initiate settlement discussions. Cases exist that strongly suggest defense counsel owes a duty to initiate settlement discussions.[127] However, there is also authority providing that a bad faith claim cannot be based solely on defense counsel's failure to initiate settlement talks.[128] To avoid the possibility of bad faith failure to settle liability, insurers with standard liability policies should consider the amount of financial risk to which the insured is potentially exposed.[129] The greater the threat of personal liability on a claim, the greater the need to initiate early settlement negotiations by defense counsel.

(2) Burning Limits Policies

Just like with standard liability policies, no case law specifically addresses whether carriers with burning limits policies are liable for failure to initiate settlement discussions. However, it seems clear that the self-depleting nature of a burning limits policy should cause insurers to begin settlement discussions as early as possible. The Rules of the Unfair Claim Practices Act are consistent with this sentiment. Under this Act, insurers are obligated to attempt "in good faith to effectuate prompt, fair and equitable settlement" after liability has become "reasonably clear."[130]

VI. Conclusion

One broad theme emerges after review of the above: The existence of burning limits obligates attorneys and insurers to provide their clients and/or insureds ***more information*** about a given claim, ***sooner***. A plaintiff attorney's failure to investigate the nature and status of a defendant's policy limits, when liability above these limits is likely, subjects her to malpractice liability. A defense attorney's failure to advise an insured that defense costs deplete policy limits when the case cannot be resolved within these limits subjects the insurer to bad faith liability. Therefore, construction defect lawyers and insurance professionals should investigate, reflexively, the nature and status of insureds' policy limits at the ***very beginning*** of the case.

As mentioned above, burning limits CGL policies are appearing ever more frequently in construction defect litigation. Contractors, who already face bankrupting workers' compensation insurance costs, are lured by the reduced premiums of such policies. Consequently, construction defect professionals will be required to tackle the complex issues created by such policies in the near future, if they have not already. Hopefully, review of this article will assist those practitioners develop economical and practical solutions to these problems for the mutual benefit of the parties involved.

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[1] Gregory S. Munro, *Defense within Limits: The Conflicts of "Wasting" or "Cannibalizing" Insurance Policies*, 62 Mont. L. Rev. 131, 132 (2001).
[2] *Id.* at 32-33.
[3] David L. Brandon, *Burning Issues: The Representation of Insureds under Burning Limits Policies Raises a Host of Ethical Issues*, 27 – APR L.A. Law 30, 30 (April 2004). *See also* Lee R. Russ and Thomas F. Segalla, *Couch on Insurance*, § 200:5 (3d ed. 2005) (discussing variations between standard and burning limits liability policies).
[4] Munro, *supra* note 1, at 133.
[5] Shaun McParland Baldwin, *Legal and Ethical Considerations for "Defense Within Limits" Policies*, 61 Def. Couns. J 89 (1994).
[6] Baldwin, *supra* note 6, at 89.
[7] *Id.*
[8] *Id.*
[9] *Id. Cf. Edwards v. Daugherty*, 883 So. 2d 932, 948 (La. 2004) (holding that Louisiana public policy prohibits a liability insurer from subtracting prejudgment interest from policy limits but does not prohibit insurers from subtracting the insured's attorneys fees and defense costs from policy limits).
[10] *See* Hartley & Hartley, *Defense Costs in the Self-Liquidating ("Burning Limits") Policies*, (1997), *at* http://www.hartley.com/plpol.html
[11] *Id.*
[12] Munro, *supra* note 1, at 137.
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.*
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] Munro, *supra* note 1, at 138.

[23] *Id.*
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*
[29] *Id.*
[30] Munro, *supra* note 1, at 139.
[31] *Id.*
[32] Munro, *supra* note 1, at 139; Baldwin, *supra* note 6, at 89.
[33] Baldwin, *supra* note 6, at 89.
[34] Munro, *supra* note 1, at 139; Baldwin, *supra* note 6, at 89.
[35] Baldwin, *supra* note 6, at 91.
[36] *Id.*
[37] *Id.*
[38] *Id.*
[39] *Id.*
[40] *Id.*
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.*
[46] *Id.*
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] Baldwin, *supra* note 6, at 92.
[55] *Id.*
[56] *See* Hartley & Hartley, *Defense Costs in the Self-Liquidating ("Burning Limits") Policies*, (1997), *at* http://www.hartley.com/plpol.html
[57] Baldwin, *supra* note 6, at 92. *See Paragon Homes, Inc. v. Ins. Co. of Pennsylvania*, Los Angeles Sup. Ct. Case No. BC194221, 2006 WL 216696 (Jan. 30, 2006) (discussing problems arising from primary carriers' failure to provide copies of their policies to the secondary carrier and failure to provide notice of their burning limits to secondary carrier).
[58] Baldwin, *supra* note 6, at 92.
[59] *Id.*
[60] Wayne Baliga, *Insurance Law: Understanding the ABC's*, 652 PLI/LIT 463, 477 (2001).
[61] Brandon, *supra* note 3, at 31.
[62] However, throughout the nation, burning limits policies have many variations. *See generally* DiMugno, *Insurance Litigation Reporter: Duty to Defend: Louisiana Supreme Court Addresses Validity of "Wasting Asset" or "Defense Costs Within Limits" Liability Policies*, 614 (West 2004) (providing a discussion of statutory and case law pertaining to burning limit policies in Minnesota, New York, Arkansas, Colorado, Montana, and Oregon). *See also Gibson v. Northfield Ins. Co.*, 2005 WL 3272380 (W.Va. 2005) (holding that an insurance provision in an automotive liability policy that allows defense costs and litigation expenses to be deducted from the limits of liability coverage is void and ineffective as against public policy)..
[63] *Lipton v. Sup. Ct.*, 48 Cal. App. 4th 1599, 1606 (Cal. Ct. App. 2d 1996).
[64] *See Helfand v. Nat'l Union Fire Ins. Co.*, 10 Cal. App. 4th 869, 883 (Cal. Ct. App. 1st 1992).
[65] Brandon, *supra* note 3, at 32.
[66] *Helfand*, 10 Cal. App. 4th at 879.

[67] *Id.*
[68] *Id.*
[69] *Helfand*, 10 Cal. App. 4th at 881.
[70] *Helfand*, 10 Cal. App. 4th at 883.
[71] Cal. Civ. Code § 1644.
[72] Cal. Civ. Code § 1654.
[73] *See* DiMugno, *Insurance Litigation Reporter: Bad Faith / Duty to Settle: Hawaii Federal District Court Permits Insured Whose Liability Insurer Is Defending to Settle Over Insurer's Objections*, 744 (West 2004) (discussing the impact of the *Weber* case on burning limits law).
[74] Cal. R. Prof. Conduct 3-500; ABA Model Rule 1.4(a).
[75] Cal. Bus. & Prof. Code § 6068(m).
[76] *See generally* Hartley & Hartley, *Prosecuting the Policy-Limits Case with Burning Limits*, (1999), *at* http://www.hartley.com/pollimpl.html
[77] Baldwin, *supra* note 6, at 97.
[78] Baldwin, *supra* note 6, at 98.
[79] *Id.*
[80] *Id.*
[81] *Id.*
[82] *See* Cal. Bus. & Prof. Code § 6068 (setting forth California attorneys' duties).
[83] *Id.*
[84] *See generally* Hartley & Hartley, *Defending the Policy-Limits Case*, (1999), *at* http://www.hartley.com/dfpollim.html; DiMugno, *Insurance Litigation Reporter: Duty to Defend: Louisiana Supreme Court Addresses Validity of "Wasting Asset" or "Defense Costs Within Limits" Liability Policies*, 614 (West 2004) (stating that "[a] conflict of interest is inherent in defense within limits (DWL) or wasting asset policies when the insurer wants to vigorously defend a claim and the insured wants to settle the claim before indemnity limits have been exhausted").
[85] Baldwin, *supra* note 6, at 98.
[86] *See* DiMugno, *Insurance Litigation Reporter: Bad Faith / Duty to Settle: Hawaii Federal District Court Permits Insured Whose Liability Insurer Is Defending to Settle Over Insurer's Objections*, 744 (West 2004) (acknowledging the numerous conflicts of interest faced by counsel defending a burning limits insured).
[87] *Id.*
[88] If the insured's liability likely exceeds policy limits, a burning limits policy is applicable, the insurer retains control of the defense, and the case resolves for an amount policy limits, the insured probably would assign breach of contract and bad faith claims to plaintiff with a covenant not to execute. In ensuing litigation, plaintiff would argue that, had the insured been given the opportunity to control his own defense, attorney fees and costs would have been less and the insured would not have had any personal liability.
[89] Baldwin, *supra* note 6, at 98.
[90] *Id.*
[91] Cal. Bus. & Prof. Code § 6068 (providing "[i]t is the duty of an attorney to do all of the following: . . . (m) To respond promptly to reasonable status inquiries of clients and to keep clients reasonably informed of significant developments in matters with regard to which the attorney has agreed to provide legal services."
[92] Brandon, *supra* note 3, at 32-33.
[93] Cal. State Bar Form Opinion 1994-134; *In re Jackson*, 170 Cal. App. 3d 773, 780 (Cal. Ct. App. 1985); Paul W. Vapnek, Mark L. Tuft, Ellen R. Peck, and Justice Howard B. Weiner, *California Practice Guide: Professional Responsibility*, § 10:290.1 (Rutter Group 2006).
[94] Cal. R. Prof. Resp. 3-700(A)(2); *Matter of Dahlz*, 4 Cal. State Bar Ct. Rptr. 269, 280 (Rev. Dept. 2001); Vapnek, et al., *California Practice Guide: Professional Responsibility*, § 10:290.
[95] Cal. R. Prof. Resp. 3-700(D); *Matter of Dahlz*, 4 Cal. State Bar Ct. Rptr. at 280; ABA Model Code ER 2-32; Los Angeles Bar Association Form Opinion 362; Vapnek, et al., *California Practice Guide: Professional Responsibility*, §§ 10:290, 10:290.3, 10:311.
[96] Brandon, *supra* note 3, at 33.
[97] Cal. Civ. Code § 2235; *Walton v. Broglio*, 52 Cal. App. 3d 400, 403 (Cal. Ct. App. 3d 1975); Brandon, *supra* note 3, at 33.
[98] Cal. Civ. Code § 2235; *Walton*, 52 Cal. App. 3d at 403; Brandon, *supra* note 3, at 33.

[99] *Bird, Marella, Boxer & Wolpert v. Sup. Ct.*, 106 Cal. App. 4th 419, 431 (Cal. Ct. App. 2d 2003); *Severson & Werson v. Bolinger*, 235 Cal. App. 3d 1569, 1572 (Cal. Ct. App. 1st 1991); Brandon, *supra* note 3, at 33.
[100] Brandon, *supra* note 3, at 34.
[101] *Id.*
[102] Brandon, *supra* note 3, at 34 (The Committee actually made its ruling pursuant to the 1980 version of California Rule of Professional Conduct 2-111. The substance of Rule 2-111 is currently included in California Rule of Professional Conduct 3-700).
[103] *Hartford Accident & Indemnity Co. v. Sup. Ct.*, 23 Cal. App. 4th 1774, 1781 (Cal. Ct. App. 1st 1994).
[104] *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 76 n.29 (Cal. 1997).
[105] *See id.* (suggesting the insurers in the case could have avoided paying unlimited defense costs "through the issuance of 'self-consuming' or 'burning limits' policies, under which the indemnification limit is reduced dollar for dollar by defense costs until zero is reached and the duty to indemnify and the duty to defend are then terminated[.]").
[106] *See* Hon. H. Walter Croskey and Hon. Rex Heeseman, *California Practice Guide: Insurance Litigation*, § 12:597 (Rutter Group 2006) (discussing additional obligations owed by carriers of burning limits policies).
[107] *See id*.
[108] *J.B. Aguerre, Inc. v. American Guarantee & Liability Ins.*, 59 Cal. App. 4th 6, 15 (Cal. Ct. App. 2d 1997).
[109] *See* Hon. H. Walter Croskey and Hon. Rex Heeseman, *California Practice Guide: Insurance Litigation*, § 12:597 (Rutter Group 2006). *See also* DiMugno, *Insurance Litigation Reporter: Bad Faith / Duty to Settle: Hawaii Federal District Court Permits Insured Whose Liability Insurer Is Defending to Settle Over Insurer's Objections*, 744 (West 2004) (concluding that an insurer's rejection of a policy limits settlement offer when defense and likely judgment exceed policy limits is arguably bad faith).
[110] *CNA Casualty of California v. Seaboard Surety Co.*, 176 Cal. App. 3d 598, 619 (Cal. Ct. App. 1st 1986). *See also Centennial Ins. Co. v. United States Fire Ins. Co.*, 88 Cal. App. 4th 105, 111 (Cal. Ct. App. 1st 2001) (holding that "[i]n choosing the appropriate method of allocating defense costs among multiple liability insurance carriers, each insuring the same insured, a trial court must determine which method of allocation will most equitably distribute the obligation among the insurers 'pro rata in proportion to their respective coverage of the risk,' as 'a matter of distributive justice and equity.' As such, the trial court's determination of which method of allocation will produce the most equitable results is necessarily a matter of its equitable judicial discretion.') (citations omitted).
[111] *Aerojet-General Corp. v. Transport Indem. Co.*, 17 Cal. 4th 38, 70 n.19 (Cal. 1997).
[112] *Centennial Ins. Co.*, 88 Cal. App. 4th at 113-14.
[113] *See, e.g.*, *CNA Casualty*, 176 Cal. App. 3d at 619 (setting forth similar example).
[114] *Id.* at 619-20; *Centennial Ins. Co.*, 88 Cal. App. 4th at 113-17.
[115] *See, e.g.*, *Centennial Ins. Co.*, 88 Cal. App. 4th at 109-10.
[116] *See Maryland Casualty Co. v. National American Ins. Co.*, 48 Cal. App. 4th 1822, 1828 (Cal. Ct. App. 4th 1996).
[117] See *Hartford Cas. Ins. Co. v. Mt. Hawley Ins. Co.*, 123 Cal. App. 4th 278, 282 (Cal. Ct. App. 2d 2004) (holding that the carrier of an additional insured general contractor was not liable for contribution to the subcontractor's insurer because of the existence of an indemnity agreement between the general contractor and subcontractor).
[118] *Communale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 659 (Cal. 1958). *See also PPG Industries, Inc. v. Transamerica Ins. Co.*, 20 Cal. 4th 310, 312 (Cal. 1999) (holding "In each policy of liability insurance, California law implies a covenant of good faith and fair dealing. This implied covenant obligates the insurance company, among other things, to make reasonable efforts to settle a third party's lawsuit against the insured. If the insurer breaches the implied covenant by unreasonably refusing to settle the third party suit, the insured may sue the insurer in tort to recover damages proximately caused by the insurer's breach").
[119] Hon. H. Walter Croskey and Hon. Rex Heeseman, *California Practice Guide: Insurance Litigation*, § 12:341 (Rutter Group 2006).
[120] *Id.*

[121] Hon. H. Walter Croskey and Hon. Rex Heeseman, *California Practice Guide: Insurance Litigation*, § 12:233 (Rutter Group 2006).
[122] *Waters v. United Services Auto. Assn.*, 41 Cal. App. 4th 1063, 1070 (Cal. Ct. App. 2d 1996).
[123] *Johansen v. California State Auto. Assn. Inter-Ins. Bureau*, 15 Cal. 3d 9, 15-16 (Cal. 1975). *See Emerald Bay Community Assoc. v. Golden Eagle Ins. Corp.*, 130 Cal. App. 4th 1078, 1090-91 (Cal. Ct. App. 4th 2005) (holding that an insured suffered no damage from an insurer's bad faith breach of its duty to defend where another on-the-risk insurance carrier paid the insured's defense costs, even when this carrier's policy had burning limits).
[124] Hon. H. Walter Croskey and Hon. Rex Heeseman, *California Practice Guide: Insurance Litigation*, § 12:288 (Rutter Group 2006).
[125] *Id.*
[126] *Johansen*, 15 Cal. 3d at 16.
[127] *See Garner v. American Mut. Liab. Ins. Co.*, 31 Cal. App. 3d 843, 847-48 (Cal. Ct. App. 3d 1973); *Brown v. Guarantee Ins. Co.*, 155 Cal. App. 2d 679, 689 (Cal. Ct. App. 2d 1957).
[128] *See Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 877 (Cal. Ct. App. 2d 1973).
[129] *See Brown*, 155 Cal. App. 2d at 689 (setting forth factors to be weighed in determining liability for bad faith failure to settle).
[130] Cal. Ins. Code § 790.03(h)(5).