PROFESSIONAL LIABILITY INSURANCE

THE RISKS INHERENT IN DIMINISHING LIMIT POLICIES

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Challenge has never been absent from the professional liability industry. One of the more fundamental challenges has been trying to reduce defense costs—relative to indemnity payments—in keeping with corresponding defense/indemnity ratios in the general liability coverage arena. Unfortunately, this has never been possible due to the unique nature of professional liability.

In 1986, the Insurance Services Office (ISO) made insurance headlines with two concepts that they hoped would become an industry standard. The first was to develop a claims-made CGL policy form. The second was to include defense costs as part of the policy's limit of liability by means of what has become known as the diminishing limits provision. Although at the time this particular provision was included within some professional liability policies, it was not widely used in 1986. Now, 8 years later, however, most professional liability policies contain diminishing limits clauses, thus becoming a standard in the professional liability industry. As diminishing limits policies become more prevalent, insureds, insurance company claim and data processing departments, outside defense counsel, and insurance agents/brokers may encounter various issues which could increase their own liabilities.

Claim Handling. Diminishing limits policies create a host of potential problems for insurance company claim departments. As is well known, the insurance industry has long been plagued with "nuisance" claims. While in some instances insurance companies make quick settlements of nuisance claims to avoid defense cost expenditures, in others, insurers will attempt to resist such claims to avoid setting a precedent, thereby sending a message to the plaintiff's bar that nuisance claims will not be honored. Considering that defense costs are deducted from the policy's aggregate limits, either course of action places an insurance company in a difficult position. Presently, it is

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believed that an insurer, to avoid "bad faith" problems, must demonstrate that it has expeditiously handled a claim, attempting to resolve it as quickly as possible, and avoiding defense costs that would impact the aggregate limit to the detriment of the policyholder. This becomes even more critical when an insured has multiple claims pending against it within a single policy period.

Defense Counsel. Another diminishing limits issue involves the ability of defense counsel and the insurer to keep the insureds adequately informed of amounts expended, expected future expenses, and remaining limits. Defense counsel must also be sensitive to another issue: it has long been held that defense counsel, although retained by the insurer, owes a primary duty and obligation of professional services to the client, traditionally defined as the policyholder, rather than the insurance company. Thus, defense counsel must demonstrate that while providing a full and complete defense to the policyholder, counsel still did not erode available remaining policy limits by wasting time and incurring unnecessary expenses in defending the policyholder. This predicament can create a potential conflict of interest between the insurance company, defense counsel, and the policyholder. If this is the case, significant claim problems will certainly arise in California, and possibly in other states. Given this situation, excellent communication between the claims department and the policyholder is required, so that the policyholder is kept abreast of what is occurring and what decisions are being made on his behalf. In addition, it may be incumbent on the insurance company to seek the policyholder's assistance and input throughout the defense process. Certainly, the policyholder should have the right to make a decision as to whether or not the "nuisance" claim should be settled or defended. Such input must be based on a clear and concise understanding of all the facts and their potential impact on the policyholder's aggregate limits.

Trial Strategy. A related concern is the problem of proceeding to trial when limits have already been "exhausted" by reserve. Under these conditions there may not be enough money available in the event of an adverse verdict or to cover defense counsel's fees. In this situation, defense counsel could seek a guarantee of payment for its services from the insurers (under an adverse verdict scenario) that exceeds the then remaining policy limits. In essence, the insurer could be asked by defense counsel to agree to increase the company's limit of liability beyond its actual contractual obligation. But if the company refuses and counsel elects to withdraw on the eve of trial, numerous bad faith and professional liability exposures could arise. This scenario becomes even more dangerous when other, unrelated claims are pending against an insured, and the one proceeding to trial could affect the availability of future funds for the other pending claims and their defense.

Insurer Data Processing Departments. Insurance company data processing departments will also be affected by diminishing limits provisions. Insurance company claim departments should provide policyholders with a loss run on a periodic basis to apprise the policyholder regarding availability of aggregate limits. This must be done on at least a quarterly basis and include: a list of all claims charged against the particular policy year, a display of all loss and expense payments, all open yet unresolved claims and their current reserves for losses and expenses, as well the potential future effect of those reserves upon the policyholder's aggregate limit of liability.

Policyholders. Diminishing limits policies give rise to yet another interesting issue. It is not uncommon for a policyholder to provide certificates of insurance to other persons or organizations, or additional insured endorsements in favor of persons or entities with which the policyholder has business relationships. Now, certificate holders and additional insureds may

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also request or require that loss runs be included with their certificates/additional insured endorsements.

Insurance Agents/Brokers. There is always a possibility that excess and umbrella insurers will not recognize an exhaustion of aggregate limits when defense costs expenditures have helped to exhaust said limits. This, in turn, presents the insured with potential gaps in coverage. Accordingly, insurance producers must closely scrutinize excess or umbrella policies with "follow form" language. In addition, there are usually serious questions regarding a primary insurer's willingness to reinstate aggregate limits, once exhausted, in the event that the policy itself still has not yet expired. Under these circumstances, an insurer will request an additional premium to reinstate the limits, which insurance producers must assess carefully in helping an insured arrive at the optimal cost benefit decision under the particular circumstances. If the premium to reinstate the limits approaches what the policyholder would have to pay in additional losses to trigger the excess coverage, such decisions will require astute analysis. Of course, insurance agents and brokers should also be provided a copy of loss runs so that they too will be in a position to provide insurance services to their policyholders in accordance with the impact of claims payments and reserves upon aggregate limits of liability.

Finally, but perhaps most important, insurance agents and brokers must make certain that their insureds understand the potential problems imposed by diminishing limits language at the outset of a policy term and assist insureds in selecting "appropriate" limits of coverage, accordingly.

Conclusion. A host of potential problems are created when insurers include diminishing limit language in their policy forms. No doubt, new and unforeseen issues are certain to arise over time in conjunction with this challenging and unique policy provision.

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In 1995, he formed what is now known as ELM Insurance Brokers, a firm that has acted as an MGA and wholesale broker of professional liability insurance and specialty lines. He has lectured extensively on professional liability issues since 1978 and authored over 64 articles in trade journals and periodicals. He is the author of *BROKER BEWARE, Selling Real Estate within the Law.* He designed a program to conduct on-site pre-underwriting risk management assessments of a client's professional liability exposures. In 1993, he was elected to the Professional Liability Underwriting Society (PLUS) Board of Trustees. After serving in all officer capacities, he was elected president in 1997. He remains a special materials expert for several RPLU courses and senior technical advisor for *The Professional Liability Manual,* first published by the International Risk Management Institute in 1990. He testifies regularly as an expert witness in cases dealing with the duties and obligations of professionals as well as on coverage and claims-made issues.

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