

Duty to or Non Duty to Defend: What is the Best Defense Provision?

By Wayne E. Bernstein

As insurance professionals, we are all familiar with “duty to defend” language commonly associated with general liability policies. But are you familiar with, or did you even know there is, “non duty to defend” language as well? This language is routinely found in public and private director’s & officer’s (D&O) liability policies and a few employment practices liability (EPL) policies. Where confusion arises is when insureds and agents do not understand the differences and true context of those clauses.

Understanding the differences

“Duty to defend” language is routinely found with most EPL and a number of private company D&O policies, as well as with almost all nonprofit D&O policies. That clause essentially states that in the event a claim is made against the named insured for an alleged wrongful act, the insurance company providing coverage at the time has the right and duty to defend the claim, even if it is groundless, false or fraudulent. Therefore, although the claim lacks merit, the carrier still has an obligation to defend the claim.

Conversely, a “non-duty to defend,” or “indemnity” policy, used exclusively for public D&O liability and very few EPL policies, states that it is the insured’s responsibility—not the insurance company’s obligation—to defend a claim when one occurs.

There are even some policy clauses that state the carrier “has the right, but not the duty to defend” a claim when one is reported. Of course, that particular clause is discretionary from the carrier’s standpoint and will depend on the merits and details of the claim at the time one is reported.

Deductible or self-insured retention

A deductible or SIR is used as a type of co-insurance, making the insured responsible for partial payment of a loss. Because a deductible and SIR operate differently, it is important to understand the difference between the two, as well as the roles

they play in the defense of a claim.

The vast majority of duty to defend policies use a deductible, which is always included as part of the defense costs and is not normally “first dollar” defense as sometimes perceived. When a deductible is used, the designated deductible amount is deducted from the total amount of a claim once a settlement is reached. Because the carrier has a duty to defend the insured, the carrier will advance all defense costs on the insured’s behalf until a settlement is reached. In situations where a claim was settled within the deductible amount, the carrier will require reimbursement from the insured for all of the defense costs it incurred. The advantage is the insured bears no out-of-pocket expense until settlement.

In contrast, the SIR is used almost exclusively in a non-duty to defend policy. When a claim is initially made, the insured typically must manage the litigation process himself until the amount of the SIR is satisfied.

Weighing the pros and cons

The most common defense clause used today is the “Duty to Defend” provision. Insurance carriers who use duty to defend clauses in their policies have the obligation to manage the litigation process from the initiation of the claim. At the same time, insurers have the right to select defense counsel, who are usually, but not always, their in-house counsel.

If the insurance carrier’s in-house counsel and claims adjusters are used, the costs for those parties generally are not considered part of the defense costs. Therefore, the overall defense costs are greatly reduced for all parties involved. However, the downside is that the insured usually has no control over the defense counsel being assigned, unless other arrangements were previously made. The duty to defend policy form is customarily used with smaller, less sophisticated organizations.

On the other hand, policies with “Non-Duty to Defend” clauses place the management of the litigation process square-

ly on the shoulders of the insured. That also includes the selection of defense counsel and payment of defense costs as they are incurred. This approach is employed mostly when public D&O policies are involved. Due to the nature of this type of D&O claim, it is in the insureds’ best interest to control their own defense when involved in that type of claim. This is particularly significant when allegations of fraud and misrepresentations are involved.

The reasons for this are fairly obvious. If the carriers providing the policy suspect the insureds have misrepresented themselves or committed dishonest, fraudulent or even criminal acts, the insurers are less likely to view the insureds in a favorable manner. In some cases, the insurers may even try to rescind the policy because of such conduct.

Such has been the case with a number of notable publicly held companies that have filed D&O claims during the past few years. One drawback to the non-duty to defend option is that the cost of defense is borne upon the insured from the outset of the claim.

It is not unusual for the litigation costs of D&O claims to total in the hundreds of thousands of dollars. If an insured does not have the financial resources to pay for a protracted defense of this nature, it can become a financial burden for an insured. For this reason, the non-duty to defend form is frequently used by more sophisticated entities experienced in complex litigation matters.

The distinguishing difference between the non-duty to defend and the duty to defend policy is that the carrier does not step-in to defend the claim until the SIR is satisfied. In practice however, it remains the sole discretion of the carrier as to how they will handle the SIR or deductible when a claim is made, because each policy contract varies, and each carrier handles claims differently.

Selection of claims counsel

As mentioned before, when a duty to defend policy is used, generally the carrier retains the right to select legal counsel. However, in some instances, the insurance

company may allow the insured to use their own defense counsel if pre-approved in advance of a claim. This is usually done at the time coverage is placed as part of the negotiation process. As an alternative, a number of insurance carriers now provide defense coverage via “panel counsel.”

Panel counsel consists of a group of pre-approved attorneys used by the carrier to handle claims on their behalf. They are experts in their field, so the panel counsel acts as the insured’s claims counsel and manages the litigation process on the insured’s behalf, while working with the carrier to settle the claim.

Because of this relationship, the cost of defense in effect is provided to the carrier at a discounted rate; the same panel is negotiating many cases on their behalf. When panel counsel is used, the insured will pre-select their choice, from a list provided and approved by the insurance carrier. This is routinely done once the policy is issued, but in some instances, the insured may have the option at the time of a claim.

A non-duty to defend policy stipulates that it is the “duty of the insured and not the insurer” to select his or her own defense counsel. Contractually, the carrier still retains the right to approve the defense counsel selected by the insured, but such consent cannot be unreasonably withheld.

As mentioned previously, with the non-duty to defend clause, the cost of

defense is borne upon the insured from the beginning of a claim and is only reimbursed by the insurance company throughout designated periods of the claim process, and only once the SIR is satisfied. To help with those costs, the insurance carrier will “advance defense costs” to reimburse the out-of-pocket expenses incurred by the insured, thus limiting the hardship on the insured’s working capital.

That type of arrangement is typically more associated with D&O policy contracts, and reimbursement is usually made quarterly or, in some cases, monthly. However, this is not without stipulations.

Under most policies, the carrier will require compliance to a number of conditions before the insured is reimbursed. As an example: The claim must be a covered claim; the SIR must be satisfied; the insured and carrier have agreed to the costs of defense. And lastly, if it is established that there is no liability under the policy, then the insured will reimburse the insurer for all costs of the defense.

Whether a deductible or SIR is used, the payment of defense costs will almost certainly reduce the limit of liability in most policies. Nevertheless, there are a few duty to defend carriers who will provide defense costs in addition to the limit of liability. That can be a big advantage for the insured and should always be sought where possible.

Also, as the market softens, there may be

further room to modify coverage in the insured’s favor. As such, a few D&O and EPL carriers have an endorsement that allows the insureds to select either the “duty to defend” option or defend claims themselves. As a rule, that option must usually be exercised within 30 days of notice of a claim.

When proposing coverage, it is important to know what “defense provision” is the correct one for your client. Depending on the sophistication of the insured, he or she may or may not know the differences. As an agent, you need to engage your client in a dialogue, which will give you some clues as to their particular needs.

Usually, an insured does not have much say in the type of policy they are getting, unless they are savvy buyers and/or have an insurance agent/broker who is familiar with the products available in the marketplace.

Of course there are no right or wrong answers when selecting the appropriate defense provision because each insured’s business and needs are different. For smaller entities, economics may play an important role, whereas a larger a larger entity may feel more comfortable using its own defense counsel.

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