

PAC MAN Insurance—Be Careful or It Will Be GAME OVER.

If you are going to play, at least know the rules.

By: Briggs F. Cheney

A growing number of professional liability policies being written in New Mexico provide for *defense within limits coverage* (DWLC)—often referred to as *Pac-Man* policies or *Pac-Man* coverage. Like the 1980 arcade and later video game where *Pac-Man* would gobble up *pac dots*, an insured's indemnity limits are reduced (eaten up) by each dollar spent on the defense. A less polite way of describing DWLC would be a *ménage a trois*¹ consisting of the insured, the defense lawyer and the plaintiff/plaintiff's lawyer. It is fraught with conflicts, tensions, duties and obligations, which often feel unnatural and wrong.

There are different varieties of DWLC—some allow for complete erosion of indemnity and some only allow erosion to a percentage of indemnity (e.g. fifty percent). New Mexico has an insurance regulation, 13 NMAC 11.2.1, which governs DWL policies, but it is not easy to apply and the insurance industry has found ways to remain in compliance and still issue eroding coverage. (13 NMAC 11.2.10 provides exceptions to the regulation by allowing the insured to select defense counsel and participate in the defense to include consent to settlement.)

There are many critics of DWLC, but before exploring some of the reasons for that criticism, why is there *Pac-Man* coverage? This writer's guess based on no real research is that DWLC provides the insurer with an insurance product that is price competitive and puts a cap on the risk. The simplicity of DWLC is semi-elegant in terms of its simplicity. When the company sells the policy, it knows the limits of its risk if a claim is filed; in theory, it will not payout more than the limits of the coverage, no matter the verdict or settlement or the cost of defense. In exchange for this certainty of risk, a company is able to offer the policy at a very competitive price that for the price-conscious, -sensitive lawyer (or the lawyer who is simply trying to satisfy Rule 16-104 (C) (1) and (2) NMSA and wants coverage at the best price), the "bargain" is a reason to buy.

Before one completely misinterprets this last thought about "bargain," being a bargain is not necessarily a bad thing. If cost is truly important and the decision for the lawyer comes down to DWLC or no coverage at all, buying a Chevrolet Biscayne² is not an irrational thing to do as long as the lawyer understands what is being purchased. Just like the Chevy Biscayne, where you

¹ The author acknowledges that "ménage a trois" commonly refers to a domestic arrangement in which three people having sexual relations occupy the same household. This more accurately captures defense within limits insurance. However, for the more sensitive reader, ménage a trois is also a song by *Alcazar*, there is an album by that name by *Baby Bush* and is a soft and pleasing red wine, reportedly easy on the palate, made by the Trinchero Family Estate in St. Helena, California.

² General Motors Chevrolet manufactured from 1958-72 the Biscayne, which was the least expensive model in the Chevrolet full-size car range (except the 1958 only Chevrolet Delray). The absence of most exterior and fancy interior trimmings remained through the life of the series, as the slightly costlier Chevrolet Bel Air offered more interior and exterior trimmings at a price significantly lower than the mid-line Chevrolet Impala.

didn't pay for the automatic windows and locks and other bells and whistles, when a claim is filed, the lawyer with Pac-Man coverage has to be more vigilant. This is not an exhaustive list, but that vigilance should include:

1. If the assigned defense counsel does not provide you with its bills to the company, insist on getting them. It is just arithmetic, but monitoring how much is being spent on defense and what is left for indemnity is important.

2. The company will provide defense counsel, but it is often smart for the insured lawyer to hire an independent lawyer who can be involved. This lawyer's involvement will depend on the claim, but if a verdict may exceed policy limits or if the calculus of defense costs will result in remaining limits to respond to a verdict or to get a case settled, having an independent lawyer who can make appropriate demands on defense counsel and the company can be critically important.

3. The earliest possible evaluation of the claim from the assigned defense counsel is very important. As we all know, evaluating a case is not easy and often cannot be done without investigation and discovery. Of course, that means the defense lawyer has to incur defense costs and that means ... you can do the arithmetic. This is another place where an independent counsel can play a part by providing a less accurate "second opinion" or in appropriately encouraging defense counsel to provide as early of an initial case analysis as possible.

4. The lawyer is forced to be vigilant because he or she has a *defense* budget. Close your eyes and pretend you've been sued for legal malpractice and your former client is claiming \$2 million in damages. In being vigilant, living within that *defense* budget you purchased with your policy, where do you cut corners to preserve your limits? Which depositions do you not take and which experts do you not retain?

It is not fair to condemn DWLC. It is an insurance product that serves a need, but the lawyer needs to respect its shortcomings.

When Pac-Man insurance is involved, it is not just the insured who has to be vigilant. Remember, it is a *ménage à trois*. Whether you are a plaintiff's lawyer or a defense lawyer, each has to pay attention to more than the keen causes of action or nifty defenses. If you don't, it may be "Game Over" before the first deposition is taken. And, when it is *game over*, the *reset* or *new game* may be one or both of you—a legal malpractice action brought against you.

Some thoughts:

- An excellent and exhaustive discussion of eroding limits coverage in the *Montana Law Review*, Gregory S. Munro, Defense Within Limits: The Conflicts of "Wasting" or "Cannibalizing" Insurance Policies, 62 Mont. L. Rev. 131 (2001). [<http://scholarship.law.umt.edu/faculty/15/>] Although somewhat dated, this law review is repeatedly cited by courts around the country.
- For the defense attorney, it is important to review an insured's insurance coverage at the very outset of the representation. If that is not possible, the defense lawyer should

send a retainer agreement to both the insured and the insurance company providing the defense that includes a provision along the following lines:

I have not reviewed the firm's professional liability insurance policy with **[name of carrier/company]**. To the extent it provides defense within limits coverage, we must be advised because it is important to note that we view that as creating a potential conflict since the cost of defense (which includes payments to this firm for legal services rendered in defending **[individual lawyer's name]** and the firm) may reduce limits available for settlement or indemnification. If that is the case, then we feel we have heightened duties **to [lawyer's name]** and his or her firm and will insist on his or her approval of defense actions. While we will not insist on **[lawyer's name]** or the firm retaining independent counsel, we will recommend they do so. Independent counsel will relieve us of having to advise the firm as to the advisability of various defense recommendations, vis-a-vis, the effect it will have on the ultimate outcome of the case and available limits for settlement or indemnity.

- For the plaintiff's attorney, it is not enough to do the requisite discovery. Get a copy of the policy, look at the limits and then file it away. The coverage has to be studied and a request for any reservation of rights letters is prudent. To fail to discover DWLC may represent a breach of the plaintiff lawyer's duty to his or her client. But the duty or obligation to the plaintiff-client is to advise the client about the realities of DWLC and the fact that an aggressive prosecution of their claims may result in the coverage for any settlement or to respond to a judgment in the plaintiff's favor may be reduced for each dollar the defense lawyer is required to work defending the case. In other words, the plaintiff's lawyer needs to advise the client, in writing, that early settlement and a reasonable attitude toward settlement is required.

Closing Thought

I talked above about the elegant simplicity of a Pac-Man policy and the company's ability to know with certainty of the risk associated with the policy it sells. But at play is that old adage: "If it seems too good to be true, it probably is."

The *ménage a trois* can end up being a *ménage a quatre*. The company can be placed in a position of being forced into settling a case for more than it is worth just to avoid the risk of a claim for bad faith. Of course, a company cannot be placed in a position of bad faith merely by its insured simply making a written demand that the company settle the case within policy limits. The niceties of that area of law are far beyond this article, but all the moving parts involved in Pac-Man coverage can put a company in the uncomfortable position of not being able to rely on its risk being limited to the limits of its policy.

All it takes is a vigilant lawyer/insured who has retained a good independent counsel, a defense lawyer who struggles with the risk that the evaluation of liability may be eclipsed by defense costs because it is an expensive case to defend and try and an astute plaintiff's counsel

who sends the perfect letter at the perfect time offering to settle for the remaining limits. Given that *perfect storm*, a company may have no choice but to settle the claim for far more than it believes the claim is worth.

There was nothing wrong with the Chevrolet Biscayne, but it had roll-up windows and no other bells and whistles. DWLC may be what fits the lawyer's needs and budget, but you have to roll up the windows.