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Christine J. Wichers

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***Brown v. Lumbermens Mutual Casualty Co.*: When Does Exhaustion of Policy Limits Terminate an Insurer's Duty to Defend?**

A liability insurance policy imposes two duties on an insurer with respect to the insured: the duty to indemnify and the duty to defend.¹ In the past, when an insurer believed liability would exceed policy limits, it argued that the latter duty is dependent on the former, and that therefore exhaustion of policy limits terminated the duty to defend. Although there is general consensus today that the duty to defend is independent of and broader than the duty to indemnify,² most courts have held that some forms of exhaustion can extinguish the duty to defend.³ Courts following this rule, however, have not agreed on the forms of exhaustion that suffice.⁴

In *Brown v. Lumbermens Mutual Casualty Co.*,⁵ the North Carolina Supreme Court addressed this problem, one of first impression in the state. The court held that when a policy reads, "Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted,"⁶ the insurer's duty to defend continues until exhaustion of coverage occurs either through settlement of a claim against the insured or through a judgment against the insured.⁷

This Note examines the language changes insurers have made in their policies in an attempt to terminate the duty to defend on exhaustion of liability coverage. It discusses the split in opinion between courts that have held exhaustion ends the duty to defend, and those that have held it does not. The Note then addresses the disagreement among courts in the former group over the form of exhaustion that suffices to end the duty. It analyzes the *Brown* court's reasoning and looks at the policy implications of the decision. The Note concludes that the decision is correct as a matter of policy, but that the court should have rested its holding on less vulnerable grounds.

In *Brown* defendant Lumbermens Mutual Casualty Company (LMCC) sold plaintiffs Doyle and Coleen Brown a \$25,000 automobile insurance policy that contained the following duty-to-defend provision:

We will pay damages for bodily injury or property damage for

1. There is no North Carolina statutory requirement that an insurer provide its insured with a defense. See, e.g., N.C. GEN. STAT. § 20-279.21 (1989). A company, however, may provide this by contract. *Brown v. Lumbermens Mut. Casualty Co.*, 326 N.C. 387, 391, 390 S.E.2d 150, 152 (1990).

2. E.g., *Waste Management of Carolinas, Inc. v. Peerless Ins. Co.*, 315 N.C. 688, 691, 340 S.E.2d 374, 377, *reh'g denied*, 316 N.C. 386, 346 S.E.2d 134 (1986); see A. WINDT, *INSURANCE CLAIMS AND DISPUTES* 201 n.262 (2d ed. 1988 & Supp. 1990) (listing cases holding that the duty to defend is independent of the duty to pay); Zulkey & Pollard, *The Duty to Defend After Exhaustion of Policy Limits, FOR THE DEF.*, June 1985, at 21, 21 ("It is a well-recognized legal principle that an insurer's duty to defend is broader than the insurer's duty to indemnify the insured.")

3. See *infra* note 64 and accompanying text. For examples of forms of exhaustion that may extinguish the duty to defend, see *infra* text accompanying note 94.

4. See *infra* notes 65-67 and accompanying text.

5. 326 N.C. 387, 390 S.E.2d 150 (1990).

6. *Id.* at 389, 390 S.E.2d at 151 (quoting policy).

7. *Id.* at 394, 390 S.E.2d at 154.

which any covered person becomes legally responsible because of an auto accident. We will settle or defend, as we consider appropriate, any claim or suit asking for these damages. In addition to our limit of liability, we will pay all defense costs we incur. Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted.⁸

When Joan Hinson brought a tort action against the Browns as a result of a car accident, LMCC hired a law firm to represent the Browns.⁹ In response to Hinson's complaint, the firm filed an answer denying any negligence by the Browns.¹⁰ In an affidavit, however, the law firm gave its opinion that the court probably would find the Browns liable, and it predicted a verdict between \$50,000 and \$75,000.¹¹ Against the Browns' wishes but at the direction of LMCC, the firm offered Hinson a \$25,000 settlement.¹² When Hinson refused the offer, LMCC paid her this amount in exchange for a release of its obligation; Hinson did not release the Browns.¹³ LMCC terminated the Browns' defense and discharged the law firm.¹⁴ The court later entered a \$45,000 judgment against the Browns, crediting to them the \$25,000 payment by LMCC.¹⁵

The Browns sued LMCC, claiming that it was obligated to defend them even after paying the policy limit. LMCC argued that by paying Hinson the full coverage, it discharged its duty to defend the Browns. The trial court entered summary judgment for LMCC.¹⁶

The North Carolina Court of Appeals reversed, holding that the duty-to-defend provision was ambiguous.¹⁷ The North Carolina Supreme Court affirmed in a four-three decision.¹⁸ It agreed with the court of appeals that the duty-to-defend provision was ambiguous because it did not specify what form of exhaustion terminated the duty to defend.¹⁹ Proof of ambiguity lay in the parties' conflicting interpretations: the Browns argued that only a settlement or judgment could exhaust the policy limits, but LMCC maintained that any man-

8. *Id.* at 389, 390 S.E.2d at 151.

9. *Id.* at 390, 390 S.E.2d at 151.

10. *Brown v. Lumbermens Mut. Casualty Co.*, 90 N.C. App. 464, 466, 369 S.E.2d 367, 368 (1988), *aff'd in part*, 326 N.C. 387, 390 S.E.2d 150 (1990).

11. *Brown*, 326 N.C. at 390, 390 S.E.2d at 151.

12. *Id.* at 390, 390 S.E.2d at 151-52.

13. *Id.* at 390, 390 S.E.2d at 152. LMCC paid Hinson pursuant to North Carolina General Statutes § 1-540.3, which allows advance payments to an injured person by a party or the party's insurer. *Id.* (citing N.C. GEN. STAT. § 1-540.3(a) (1983)).

14. *Id.*

15. *Id.*

16. *Id.* at 391, 390 S.E.2d at 152.

17. *Brown v. Lumbermens Mut. Casualty Co.*, 90 N.C. App. 464, 477, 369 S.E.2d 367, 374 (1988), *aff'd in part*, 326 N.C. 387, 390 S.E.2d 150 (1990). The supreme court did not review the decision of the court of appeals that an insured cannot hold her insurer vicariously liable for the negligence of an attorney it has hired, because the attorney is an independent contractor. For an analysis of this decision of the court of appeals, see Note, *Brown v. Lumbermens Mutual Casualty Co.: The Rock, the Hard Place, and the Insurance Defense Attorney*, 67 N.C.L. REV. 1424 (1989).

18. *Brown*, 326 N.C. at 397, 390 S.E.2d at 156. Chief Justice Exum wrote the majority opinion, which was joined by Justices Frye, Martin, and Mitchell. Justice Whichard wrote the dissent, which was joined by Justices Meyer and Webb.

19. *Id.* at 393-94, 390 S.E.2d at 153-54.

ner of payment would suffice.²⁰ The supreme court affirmed the court of appeals decision to interpret the provision against LMCC, and concluded that LMCC's duty to defend the Browns did not end until there was a settlement or judgment.²¹ In his opinion for the majority, Chief Justice Exum relied in part on supporting opinions from courts in three states and one federal district that have interpreted identical language.²²

Justice Whichard dissented, arguing that there was no ambiguity.²³ According to the dissent's examination of language changes in duty-to-defend provisions over the past twenty-five years, the majority's interpretation amended the disputed provision by including words that LMCC patently omitted.²⁴ Justice Whichard also claimed that the majority's interpretation of the provision "render[ed] it [the provision] meaningless surplusage," because the duty to defend, if it does not end earlier, always terminates on settlement or judgment.²⁵ The dissent went on to distinguish the cases the majority claimed to follow,²⁶ and then argued that the majority's interpretation ran counter to the public policy of the state because it discouraged payments to claimants before judgment or full settlement.²⁷

Because *Brown* decided an issue of first impression in North Carolina, it is helpful to examine other courts' analyses of the problem. It is important, however, to distinguish cases interpreting different policy language, for the insurance industry has changed the wording of the standard liability policy several times. Before 1955 the defense coverage clause was separate from the liability coverage clause, and the policy limited the insurer's duty to defend only by prefacing the defense provision. The preface stated that the insurer would defend only suits "[a]s respects the insurance afforded by the other terms of this policy under coverages A [bodily injury liability] and B [property damage liability]." ²⁸ In 1955 the insurance industry changed the preliminary language slightly, to read: "With respect to such insurance as is afforded by this policy for bodily injury liability and for property damage liability." ²⁹ The defense coverage clause and the liability coverage clause remained separate.³⁰ In 1956 the drafters merged the defense coverage clause into the liability coverage clause and changed the

20. *Id.* at 394, 390 S.E.2d at 154.

21. *Id.* Courts resolve contractual ambiguity against the drafter, in this case the insurer. *Woods v. Nationwide Mut. Ins. Co.*, 295 N.C. 500, 506, 246 S.E.2d 773, 777 (1978).

22. *Brown*, 326 N.C. at 394-96, 390 S.E.2d at 154-55 (citing *Stanley v. Cobb*, 624 F. Supp. 536, 537 (E.D. Tenn. 1986); *Samplly v. Integrity Ins. Co.*, 476 So. 2d 79, 83 (Ala. 1985); *Anderson v. United States Fidelity & Guar. Co.*, 177 Ga. App. 520, 521, 339 S.E.2d 660, 661 (1986); *Pareti v. Sentry Indem. Co.*, 536 So. 2d 417, 420-21 (La. 1988)).

23. *Id.* at 397-98, 390 S.E.2d at 156 (Whichard, J., dissenting).

24. *Id.* at 399, 390 S.E.2d at 157 (Whichard, J., dissenting).

25. *Id.* at 400, 390 S.E.2d at 157 (Whichard, J., dissenting).

26. *Id.* at 400-01, 390 S.E.2d at 158 (Whichard, J., dissenting).

27. *Id.* at 402-03, 390 S.E.2d at 158-59 (Whichard, J., dissenting).

28. Van Vugt, *Termination of the Insurer's Duty to Defend by Exhaustion of Policy Limits*, 44 INS. COUNS. J. 254, 256 (1977) (quoting N. RISJARD & J. AUSTIN, *AUTOMOBILE LIABILITY INSURANCE CASES, STANDARD PROVISIONS AND APPENDIX 2* (1964)).

29. *Id.* (quoting N. RISJARD & J. AUSTIN, *AUTOMOBILE LIABILITY INSURANCE CASES, STANDARD PROVISIONS AND APPENDIX 16* (1964)).

30. *Id.*

language limiting the duty to defend. The revised policy provided that the insurer would defend only suits " 'seeking damages which are payable under the terms of this policy.' " ³¹ In 1966 the drafters again changed the language limiting the duty to defend: " '[T]he company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements.' " ³² The insurance industry effected these changes to make clear that the insurer's duty to defend extends only as far as its duty to indemnify, and that therefore an insurer terminates its duty to defend by paying the policy limits in any manner. ³³ Nonetheless, courts have been far from unanimous in rendering such an interpretation.

The decisions construing the pre-1955 policy language are split. Some cases focus on the restrictiveness of the preliminary language and hold that the duty to defend is dependent on the duty to indemnify; therefore, payment of the policy limit terminates the duty to defend. ³⁴ At least one court also based its opinion on the anomaly of requiring an insurer with no financial interest in the outcome of the case to defend an insured. ³⁵ Cases holding that the duty to defend is independent of the duty to pay, and that therefore exhaustion of coverage limits does not terminate the duty to defend, focus on the policy language providing that "the company shall defend any suit" and the separateness of the defense coverage clause and the liability coverage clause. ³⁶

There is also a split in opinions interpreting the 1955 policy language. Cases holding that exhaustion of policy limits ends the duty to defend focus on the changed language, construing "such insurance as is afforded by this policy" to refer to the amount of liability coverage afforded. ³⁷ They also point out that the limiting phrase immediately precedes the defense agreement. ³⁸ Courts that have interpreted the 1955 policy against the insurer have held that the duty to

31. *Id.* at 257 (quoting N. RISJARD & J. AUSTIN, *AUTOMOBILE LIABILITY INSURANCE CASES, STANDARD PROVISIONS AND APPENDIX 34* (1964)).

32. *Id.* (quoting N. RISJARD & J. AUSTIN, *AUTOMOBILE LIABILITY INSURANCE CASES, STANDARD PROVISIONS AND APPENDIX 265 app.* (1964)).

33. *Id.* at 256.

34. *E.g.*, *General Casualty Co. v. Whipple*, 328 F.2d 353, 357 (7th Cir. 1964) (applying Illinois law); *Denham v. La Salle-Madison Hotel Co.*, 168 F.2d 576, 584 (7th Cir.) (same), *cert. denied*, 335 U.S. 871 (1948); *see supra* text accompanying note 28.

35. *Lumbermen's Mut. Casualty Co. v. McCarthy*, 90 N.H. 320, 323, 8 A.2d 750, 752 (1939).

36. *E.g.*, *American Casualty Co. v. Howard*, 187 F.2d 322, 326 (4th Cir. 1951) (applying South Carolina law); *Anchor Casualty Co. v. McCaleb*, 178 F.2d 322, 325 (5th Cir. 1949) (applying Texas law); *St. Paul Fire & Marine Ins. Co. v. Thompson*, 150 Mont. 182, 187-88, 433 P.2d 795, 798 (1967); *American Employers Ins. Co. v. Goble Aircraft Specialties, Inc.*, 205 Misc. 1066, 1073-74, 131 N.Y.S.2d 393, 400 (N.Y. Sup. Ct. 1954), *appeal withdrawn*, 1 A.D.2d 1008, 154 N.Y.S.2d 835 (N.Y. App. Div. 1956); *see supra* text accompanying note 28.

37. *E.g.*, *Allstate Ins. Co. v. Montgomery Trucking Co.*, 328 F. Supp. 415, 416-17 (N.D. Ga. 1971); *Commercial Union Ins. Co. v. Adams*, 231 F. Supp. 860, 866 (S.D. Ind. 1964); *Liberty Mut. Ins. Co. v. Mead Corp.*, 219 Ga. 6, 9, 131 S.E.2d 534, 535-36 (1963); *Oda v. Highway Ins. Co.*, 44 Ill. App. 2d 235, 255-56, 194 N.E.2d 489, 500 (1963); *Sutton Mut. Ins. Co. v. Rolph*, 109 N.H. 142, 144, 244 A.2d 186, 188 (1968); *see supra* text accompanying note 29.

38. *E.g.*, *Keene Corp. v. Insurance Co.*, 597 F. Supp. 946, 950-51 (D.D.C. 1984), *vacated on other grounds*, 631 F. Supp. 34 (D.D.C. 1985) (issues rendered moot by settlement pending appeal).

defend is independent of and broader than the duty to indemnify.³⁹ At least one case holds that the duty to defend continues after judgment or settlement;⁴⁰ the court supported its opinion by declaring the policy language ambiguous and by turning to the state's public policy of protecting insureds.⁴¹

Only one case interprets the 1956 policy. In *Simmons v. Jeffords*⁴² the court construed the language as obligating the insurer to defend the insured until final settlement or judgment.⁴³ The court rejected the insurer's attempt to tender the policy limits into court before settlement or judgment.⁴⁴

The only court interpreting the post-1966 policy reached the same conclusion. In *Conway v. Country Casualty Insurance Co.*,⁴⁵ the Illinois Supreme Court held that the duty to defend does not end when the insurer pays the policy limits to the claimant and that the payment does not result in a release of the insured.⁴⁶ The court underscored the unambiguous language of the policy, which referred to "judgments or settlements;" since neither had occurred, the insurer could not claim relief of its duty to defend.⁴⁷ In a case decided five years later by the same court, the court relieved the insurer of its duty to defend when it paid the policy limits through judgments and settlements.⁴⁸

The language variations described above are different forms of the standard liability policy. Other cases have interpreted policies that, like the *Brown* policy, do not fall into one of these categories. The policy in *Gross v. Lloyds of London Insurance Co.*⁴⁹ provided that exhaustion would occur by payment of judgments or settlements "or after such limit of the Company's liability has been tendered for settlements."⁵⁰ The Wisconsin Supreme Court interpreted the added language as contemplating payment before judgment or settlement; the insurer therefore could terminate its duty to defend by tendering the insured's policy limits into court.⁵¹ In *National Union Insurance Co. v. Phoenix Assurance Co.*,⁵² the court released the insurer from its duty to defend after it deposited the

39. *E.g.*, *Aetna Casualty & Sur. Co. v. Certain Underwriters at Lloyds of London*, 56 Cal. App. 3d 791, 804, 129 Cal. Rptr. 47, 55 (1976) (primary insurer's duty to defend continued, but court ordered excess carriers to reimburse primary insurer for costs beyond the policy limits); *Travelers Indem. Co. v. East*, 240 So. 2d 277, 279 (Miss. 1970) ("The defense clause . . . is . . . a contractual right of the insured, for which he is paid a premium. . . ."); *Prince v. Universal Underwriters Ins. Co.*, 143 N.W.2d 708, 717 (N.D. 1966) ("The defendant . . . had a duty to defend all actions against the plaintiff regardless of the amount involved.").

40. *Commercial Union Ins. Co. v. Pittsburgh Corning Corp.*, 553 F. Supp. 425, 431 (E.D. Pa. 1981).

41. *Id.* at 429, 431.

42. 260 F. Supp. 641 (E.D. Pa. 1966).

43. *Id.* at 642.

44. *Id.* at 641; *see supra* text accompanying note 31.

45. 92 Ill. 2d 388, 442 N.E.2d 245 (1982).

46. *Id.* at 395, 442 N.E.2d at 247.

47. *Id.* at 396, 442 N.E.2d at 248; *see supra* text accompanying note 32.

48. *Zurich Ins. Co. v. Raymark Indus.*, 118 Ill. 2d 23, 56, 514 N.E.2d 150, 165 (1987).

49. 121 Wis. 2d 78, 358 N.W.2d 266 (1984).

50. *Id.* at 83, 358 N.W.2d at 269.

51. *Id.* at 89, 358 N.W.2d at 272. The insurer could not terminate its duty to defend on this occasion, however, because it had not highlighted the added wording in the policy or otherwise given clear notice to the insured of the substantial change in the language. *Id.* at 88, 358 N.W.2d at 271.

52. 301 A.2d 222 (D.C. 1973).

amount of the policy limit with the court because the policy stated that the duty ended when the insurer "paid or tendered or deposited in court such part of such judgment as does not exceed the limit of the company's liability."⁵³ The *Delaney v. Vardine Paratransit, Inc.*⁵⁴ court held that use of the language "[o]ur payment of liability insurance limit ends our duty to defend or settle" did not release the insurer of its duty to defend when it paid the policy limits directly to the claimant who had sued the insured.⁵⁵ In *Batdorf v. Transamerica Title Insurance Co.*,⁵⁶ the court released the insurer from its duty to defend after it paid its insureds the policy limits. The *Batdorf* policy contained perhaps the most explicit language interpreted by a court so far:

The Company shall have the right to . . . defend the insured . . . reserving however, the option at any time of settling the claim or paying the amount of this policy in full.

. . . .

The Company may at any time pay this policy in full, whereupon all liability of the Company shall terminate. . . . The liability of the Company shall in no case exceed the actual loss of the insured and costs which the Company is obligated to pay.⁵⁷

All courts interpreting the *Brown* wording, which is the post-1966 language without the last six words, "by payments of judgments or settlements," have reached the conclusion the *Brown* court did: only exhaustion of policy limits by way of judgment or settlement extinguishes the insurer's duty to defend. The *Stanley v. Cobb*⁵⁸ court read the "[w]e will settle or defend" language as providing the only two options for exhaustion.⁵⁹ The courts in *Stanley, Samply v. Integrity Insurance Co.*⁶⁰ and *Anderson v. United States Fidelity & Guaranty Co.*⁶¹ rejected the claim that an insurer's duty to defend ends when it pays the policy limits into court. The court in *Pareti v. Sentry Indemnity Co.*⁶² released the insurer from its duty to defend because a good-faith settlement had exhausted the policy limits.⁶³

This overview of cases shows that the issue in *Brown* concerns not one but two questions. First, does exhaustion of liability limits terminate the duty to defend? If not, the insurer is obligated to defend the insured until the very end—that is, until resolution of all claimants' actions and conclusion of all appeals. Very few courts have reached this conclusion; those that have were inter-

53. *Id.* at 224-25. Another court reached the same conclusion when an insurer using almost identical policy language tendered its policy limits into court in an interpleader action. See *Commercial Union Ins. Co. v. Adams*, 231 F. Supp. 860, 866 (S.D. Ind. 1964).

54. 132 Misc. 2d 397, 504 N.Y.S.2d 70 (N.Y. Sup. Ct. 1986).

55. *Id.* at 398, 504 N.Y.S.2d at 71.

56. 41 Wash. App. 254, 702 P.2d 1211 (1985).

57. *Id.* at 256-57, 702 P.2d at 1212-13.

58. 624 F. Supp. 536 (E.D. Tenn. 1986).

59. *Id.* at 537.

60. 476 So. 2d 79, 83-84 (Ala. 1985).

61. 177 Ga. App. 520, 522, 339 S.E.2d 660, 661 (1986).

62. 536 So. 2d 417 (La. 1988).

63. *Id.* at 424.

preting pre-1966 policy language.⁶⁴ Second, if exhaustion does terminate the duty to defend, what form of exhaustion suffices? The *Brown* court, following the majority trend, held that only exhaustion through settlement or judgment suffices.⁶⁵ Other courts have approved exhaustion by way of the insurer's tendering the policy limits into court or to the insured.⁶⁶ Notably, no court has held that LMCC's method of exhaustion, tendering the coverage limits to the claimant, terminates the duty to defend.⁶⁷

Against this backdrop it is easier to understand the ambiguity dispute in *Brown*. The majority and dissent agreed on the answer to the first question: the *Brown* policy language explicitly declares that exhaustion of liability limits terminates the duty to defend. All the justices conceded that the insurer is not obligated to pay for an appeal.⁶⁸ They disagreed, however, on the second ques-

64. *E.g.*, *Commercial Union Ins. Co. v. Pittsburgh Corning Corp.*, 553 F. Supp. 425, 430-31 (E.D. Pa. 1981); *Aetna Casualty & Sur. Co. v. Certain Underwriters at Lloyds of London*, 56 Cal. App. 3d 791, 804, 129 Cal. Rptr. 47, 55 (1976); *Travelers Indem. Co. v. East*, 240 So. 2d 277, 280 (Miss. 1970); *American Employers Ins. Co. v. Goble Aircraft Specialties, Inc.*, 205 Misc. 1066, 1073, 131 N.Y.S.2d 393, 400 (N.Y. Sup. Ct. 1954), *appeal withdrawn*, 1 A.D.2d 1008, 154 N.Y.S.2d 835 (N.Y. App. Div. 1956).

65. Although LMCC did not make the argument, an insurer might label payment to a plaintiff in partial satisfaction of his claim against the insured a "partial settlement" and contend that it has met the *Brown* requirement that exhaustion occur through judgment or settlement. A commentator from the insurance industry rejects this proposition:

The better reasoning would seem to support the view that an agreement whereby the insurer tenders its policy limits to a single claimant in exchange for a partial release of his claim against the insured is not in fact a "settlement" but merely establishes a credit against the insured's ultimate liability, and therefore a payment of policy limits pursuant to such an agreement would not terminate the duty to defend.

Van Vugt, *supra* note 28, at 264 (the author bases his position on a reading of the post-1966 standard liability policy, not the *Brown* policy).

66. *E.g.*, *Commercial Union Ins. Co. v. Adams*, 231 F. Supp. 860, 866 (S.D. Ind. 1964) (insurer's duty to defend ended when it tendered policy limits unconditionally into court in an interpleader action); *National Union Ins. Co. v. Phoenix Assurance Co.*, 301 A.2d 222, 225 (D.C. 1973) (duty to defend ended when insurer paid amount of policy limits into court); *Batdorf v. Transamerica Title Ins. Co.*, 41 Wash. App. 254, 258, 702 P.2d 1211, 1213 (1985) (court relieved insurer of duty to defend when it paid insureds the amount of liability coverage).

67. At least two courts have rejected this form of exhaustion. In *Conway v. Country Casualty Insurance Co.*, the insurer paid the claimant with the insured's consent, but she released neither the insurer nor the insured. 92 Ill. 2d 388, 395, 442 N.E.2d 245, 247 (1982). In rejecting the insurer's claim that payment of the policy limit terminated its duty to defend the insured, the Illinois Supreme Court relied on state law holding that the duty to defend is not dependent on the duty to indemnify, but instead arises from the insurance contract. *Id.* at 394, 442 N.E.2d at 247. Because the policy expressly provided that the insurer could terminate its duty to defend by paying the policy limits in "any judgments or settlements," and there was neither a judgment nor a settlement, the court held that the insurer did not terminate its duty to defend. *Id.* at 396, 442 N.E.2d at 248; see *supra* notes 45-47 and accompanying text.

In *Delaney v. Vardine Paratransit, Inc.*, the insurer "unilaterally, paid its policy limit of \$5,000 to plaintiffs without regard to settlement of the litigation or any further exposure of its insured." 132 Misc. 2d 397, 398, 504 N.Y.S.2d 70, 71 (N.Y. Sup. Ct. 1986). The New York Supreme Court, holding that the insurer had not terminated its duty to defend, relied on a state regulation that mandates certain provisions for automobile liability insurance policies. The regulation states: "The amounts so incurred under this subdivision, except settlement of claims and suits, shall be payable by the company in addition to the applicable policy limits." N.Y. COMP. CODES R. & REGS. tit. 11, § 60.1(b) (1985). The court held that the regulation "clearly anticipates that the insurer may not unilaterally avoid payment of defense costs and related expenses by the ex parte payment of the limits of its policy." *Delaney*, 132 Misc. 2d at 398, 504 N.Y.S.2d at 71; see *supra* note 54 and accompanying text.

68. Because the issue was not before the court, it is not clear how many justices would find that

tion. The majority found the *Brown* language ambiguous because it is unclear what form of exhaustion terminates the duty to defend.⁶⁹ The dissent claimed that there is no ambiguity: "[T]he only reasonable interpretation is that by paying its full policy limits to the party injured by its insured, defendant 'exhausted' its limit of liability and ended its duty to settle or defend."⁷⁰

The North Carolina Supreme Court is the first court to base its interpretation of the *Brown* policy language on a finding of ambiguity. Four other courts interpreting the same language have reached holdings consistent with *Brown*, but none found ambiguity. The *Stanley*⁷¹ and *Anderson*⁷² courts held that the language is not ambiguous: it clearly requires exhaustion through settlement or judgment. The *Samplly* court did not mention the ambiguity issue.⁷³ The *Pareti* court held that an insurer may terminate its defense obligations under the express terms of the policy by entering into a good-faith settlement for the policy limits.⁷⁴ The *Pareti* court found no ambiguity because there was a settlement, but had there been a tender of policy limits the same language arguably would have been ambiguous.⁷⁵

The vulnerability of the ambiguity argument is indicated to some extent by the justices' votes: although there was only one dissenter among all the judges deciding *Samplly*, *Stanley*, *Pareti*, and *Anderson*, *Brown* is a four-three decision. Ambiguity is a vulnerable basis because it is largely a question of fact, not of law. For example, the majority cited several cases holding that a difference in the parties' interpretations is a factor going toward a finding of ambiguity, although such a conflict is not dispositive.⁷⁶ "A difference of judicial opinion regarding proper construction of policy language" is also some evidence that the provision is ambiguous.⁷⁷ Arguably the potential for judges changing their minds is higher with such a fact-based inquiry than it is with a more law-based analysis.

the duty to defend ends when there is a judgment or settlement with only one of several claimants. Nor is it possible to know how many justices would find that the insurer has a continuing duty to defend the insured in a codefendant's suit for contribution or indemnification. At least one commentator declares it "well settled" that the duty to defend does not continue in these two situations. Van Vugt, *supra* note 28, at 263.

69. *Brown*, 326 N.C. at 394, 390 S.E.2d at 154.

70. *Id.* at 398, 390 S.E.2d at 156 (Whichard, J., dissenting).

71. *Stanley v. Cobb*, 624 F. Supp. 536, 537 (E.D. Tenn. 1986).

72. *Anderson v. United States Fidelity & Guar. Co.*, 177 Ga. App. 520, 521, 339 S.E.2d 660, 661 (1986).

73. *Samplly v. Integrity Ins. Co.*, 476 So. 2d 79, 81-83 (Ala. 1985).

74. *Pareti v. Sentry Indem. Co.*, 536 So. 2d 417, 423 (La. 1988). The court went on to state that the insurer must "make every effort to avoid prejudicing the insured by the timing of its withdrawal from litigation," and "make allowances for the time that the insured will need to retain new counsel, and should continue to represent the insured after the settlement, if necessary, until new counsel can be retained." *Id.*

75. *Id.* at 421 n.3.

76. *Brown*, 326 N.C. at 392, 390 S.E.2d at 153 (citing *St. Paul Fire & Marine Ins. Co. v. Freeman-White Assoc.*, 322 N.C. 77, 83, 366 S.E.2d 480, 484 (1988); *Mazza v. Medical Mut. Ins. Co.*, 311 N.C. 621, 630, 319 S.E.2d 217, 223 (1984); *Trust Co. v. Insurance Co.*, 276 N.C. 348, 354, 172 S.E.2d 518, 522 (1970)).

77. *Id.* (citing *Maddox v. Insurance Co.*, 303 N.C. 648, 654, 280 S.E.2d 907, 910 (1981); *Electric Co. v. Insurance Co.*, 229 N.C. 518, 521, 50 S.E.2d 295, 297 (1948); Annotation, *Insurance—Ambiguity—Split Court Opinions*, 4 A.L.R.4TH 1253, 1255 (1981)).

The decision would have had the same effect, yet stood on firmer ground, had the court based it on the reasonable interpretation that "[o]ur duty to settle or defend" unambiguously defines the only two methods of exhaustion.⁷⁸ This also would have given the North Carolina insurance industry clearer guidelines for changing the policy language. Such a holding would have told insurers that they need to erase "to settle or defend" from their policies. As the decision stands, it tells insurers only that the *Brown* policy language is ambiguous; it does not tell them how to remove the ambiguity to attain the effects they seek.

Although the dissent criticized the majority's claim of ambiguity, its attack is weak in that it relies on *Pareti*, *Stanley*, and *Anderson*, cases whose holdings are consistent with *Brown*. The dissent flip-flopped by turning to these cases to support the argument that the policy language is unambiguous,⁷⁹ and then distinguishing their holdings by claiming a significant factual difference.⁸⁰

The dissenters argued that an insurer necessarily exhausts policy limits by tendering the amount to a claimant, as in *Brown*, because it will not get the money back.⁸¹ In contrast, by tendering the amount into court, as in *Anderson*, *Samplly*, and *Stanley*, the insurer will recover the sum if it makes the tender conditional on the insured being found liable and the insured is then found not liable.⁸² The weakness of this argument is that it considers only the claimant and ignores the insured, to whom, after all, the defense is of value. Professor Appleman asserts:

[T]he insurer's duty is both to defend actions *and* to pay judgment against the insured. Otherwise, where the damages exceed the policy coverage, the insurer could walk into court, toss the amount of the policy on the table, and blithely inform the insured that the rest was up to him. This would obviously constitute a breach of the insurer's contract to defend actions against the insured, for which premiums had been paid, and should not be tolerated by the courts.⁸³

Although it was an insurer's attempt to tender policy limits into court that prompted the *Simmons* court to declare that "a most significant protection afforded by the policy—that of defense—is rendered a near nullity,"⁸⁴ the same concern applies when the insurer pays the amount directly to the claimant.

To distinguish further the tendering of policy limits into court and to the claimant, the dissent argued that *Brown* runs counter to the North Carolina

78. This was the basis for the decisions in *Stanley* and *Anderson*. *Stanley v. Cobb*, 624 F. Supp. 536, 537 (E.D. Tenn. 1986); *Anderson v. United States Fidelity & Guar. Co.*, 177 Ga. App. 520, 521, 339 S.E.2d 660, 661 (1986). Nonetheless, the majority's finding of ambiguity is defensible. For a recitation of the court's chief argument that the method of exhaustion is ambiguous, see *infra* text accompanying note 94 (listing various methods LMCC may have intended).

79. *Brown*, 326 N.C. at 397-98, 390 S.E.2d at 156 (Whichard, J., dissenting).

80. *Id.* at 400-01, 390 S.E.2d at 158 (Whichard, J., dissenting). Opinions from other courts seem to indicate that the factual distinction does not support the dissent's argument, but cuts against it. See *supra* note 67 and accompanying text.

81. *Brown*, 326 N.C. at 401, 390 S.E.2d at 158 (Whichard, J., dissenting).

82. *Id.* (Whichard, J., dissenting).

83. 8 J. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4685, at 21-22 (1942).

84. *Simmons v. Jeffords*, 260 F. Supp. 641, 642 (E.D. Pa. 1966).

public policy that encourages insurers to make advance partial payments to claimants before final settlements.⁸⁵ Although *Brown* does not further encourage partial payments to claimants, neither does it discourage such payments, as the dissent contends. Section 1-540.3(a) still encourages insurers to make partial payments by declaring that the payments do not constitute an admission of liability by either the insured or the insurer;⁸⁶ *Brown's* only effect is that the payments will not relieve the insurer of its duty to defend the insured. Moreover, the dissent's policy argument ignores the state's countervailing public policy, which is to give effect to all parts of a contract,⁸⁷ including the "significant protection . . . of defense."⁸⁸

Another argument of the dissent is that the majority's interpretation amends the disputed provision to include words that LMCC patently omitted.⁸⁹ The *Brown* policy lacks language that the post-1966 policy contained: "[T]he company shall not be obligated to pay any claim or judgment or to defend any suit after the applicable limit of the company's liability has been exhausted by payment of judgments or settlements."⁹⁰ Because "[t]he language specifying means of exhaustion of policy limits is patently absent in the contract at issue here," Justice Whichard argued that the court should have given effect to the drafters' clear intent to leave limitless the forms of exhaustion that end the insurer's duty to defend.⁹¹ Although the argument is attractive in theory, it does not defeat the majority's finding of ambiguity. That is, whether or not the omission of "by payments of judgments or settlements" is purposeful, the court must resolve the ambiguous result against the drafter.

Even without a finding of ambiguity, the dissent's argument is unpersuasive because the language leaves the insured unwarned.⁹² It is unlikely that there are many insureds who, on reading the *Brown* proviso, contemplate the multiple avenues of escape open to the insurer:⁹³ paying the policy limits into court and

85. See N.C. GEN. STAT. § 1-540.3(a) (1983) (allowing for partial payments before settlement).

86. *Id.*

87. *Brown*, 326 N.C. at 393, 390 S.E.2d at 153 (citing *Bolton Corp. v. T.A. Loving Co.*, 317 N.C. 623, 628, 347 S.E.2d 369, 372 (1986)).

88. *Id.* at 396-97, 390 S.E.2d at 155 (quoting *Simmons v. Jeffords*, 260 F. Supp. 641, 642 (E.D. Pa. 1966)).

89. *Id.* at 399, 390 S.E.2d at 157 (Whichard, J., dissenting).

90. Van Vugt, *supra* note 28, at 257 (emphasis added) (quoting N. RISJARD & J. AUSTIN, *AUTOMOBILE LIABILITY INSURANCE CASES, STANDARD PROVISIONS AND APPENDIX* 265 app. (1964)).

91. *Brown*, 326 N.C. at 399, 390 S.E.2d at 157 (Whichard, J., dissenting). The dissent also argued that the majority's interpretation of the disputed language renders it "meaningless surplusage," because the duty to defend, if it does not end earlier, always terminates on settlement or judgment. *Id.* at 400, 390 S.E.2d at 157 (Whichard, J., dissenting). The argument fails, however, for the provision tells the insured that the insurer will not pay to appeal the case once there is a judgment. Although the *Brown* court did not decide the issue, the provision may also inform the insured that the duty to defend stops on judgment or settlement in other situations in which the insured continues to need a defense. See *supra* note 68.

92. See *Kosce v. Liberty Mut. Ins. Co.*, 159 N.J. Super. 340, 345-46, 387 A.2d 1259, 1262 (Super. Ct. Law Div. 1978) ("When construing language covering an obligation such as the duty to defend the insured, the court must look to the reasonable expectations of the insured.").

93. See *id.* at 346, 387 A.2d at 1262 ("We are dealing with language in a long, detailed insurance policy which an insured would find difficult to understand even after painstaking study.").

interpleading conflicting claimants, paying the limits to one of several claimants in exchange for a settlement of that one claim against the insured, paying the limits in full or partial satisfaction of a judgment against the insured, advancing the amount to the insured without investigating available defenses, or paying the limits to the claimant in return for a release of the insurer but not the insured.⁹⁴ When courts have approved termination of the duty to defend on unilateral tender of policy limits, they have had before them much more explicit policy language. Unlike the *Brown* policy, the policies in *Gross*,⁹⁵ *National Union*,⁹⁶ *Batdorf*,⁹⁷ and *Commercial Union*⁹⁸ did not leave the term "exhausted" undefined. Although by specifying the means of exhaustion an insurer may be faced with a form of exhaustion it did not contemplate, this route is the only fair one for insureds. To leave the forms of exhaustion limitless is to take advantage of the insured, who is not alerted to the issue without some affirmative language in the contract defining "exhaustion." Moreover, the insurer is the party in the best position to raise and clarify the issue.

Even assuming that an insured reading the policy language used in *Brown* understands that the insurer readily can escape the duty to defend, such a contract may be void as against public policy. Even those in the insurance industry concede that "an insurer cannot unilaterally pay money and walk away."⁹⁹ One industry article states:

[E]ven in jurisdictions that have . . . held that an insurer can terminate its defense obligation by paying the maximum amount of coverage specified by the policy, it has been widely accepted that the insurer cannot avoid its obligation to defend against an insured's contingent liability by early payment of the policy limits without effectuating a settlement or without obtaining the permission of the insured.¹⁰⁰

Professor Long agrees. He writes that the duty to defend should not end on exhaustion of the policy limit when the result would prejudice the insured.¹⁰¹ He argues that an insurer should not be allowed to pay the policy limit to its insured and thereby leave the insured to fend for himself, because this is an unjustified attempt by the insurer to free itself from its contractual duty to defend.¹⁰²

The duty-to-defend provision is a way to prevent an insurer from abandoning its insured by paying its policy limits into court or to the claimant, leav-

94. *Brown*, 326 N.C. at 394, 390 S.E.2d at 154. Of course, these options are not available to the insurer if a court declares them against public policy or if the insurer discharges them in bad faith.

95. *Gross v. Lloyds of London Ins. Co.*, 121 Wis. 2d 78, 83, 358 N.W.2d 266, 269 (1984).

96. *National Union Ins. Co. v. Phoenix Assurance Co.*, 301 A.2d 222, 224-25 (D.C. 1973).

97. *Batdorf v. Transamerica Title Ins. Co.*, 41 Wash. App. 254, 256-57, 702 P.2d 1211, 1212-13 (1985).

98. *Commercial Union Ins. Co. v. Adams*, 231 F. Supp. 860, 865 (S.D. Ind. 1964); see *supra* note 53.

99. Zulkey, *When Can and How Does an Insurer Properly Exhaust Its Limits?*, 56 DEF. COUNS. J. 202, 205 (1989).

100. Zulkey & Pollard, *supra* note 2, at 23.

101. R. LONG, THE LAW OF LIABILITY INSURANCE § 5-25, at 5-179 (1990).

102. *Id.* § 5.26, at 5-184.

ing the insured with litigation and possible appeals.¹⁰³ If an insurer can do this by specifically declaring in the policy its right to this option, the insurer is merely putting the insured on notice that he is obtaining a valueless contractual right.¹⁰⁴

If an insurer wishes to escape its duty to defend when it believes liability will exceed the policy limit, it should make the contract language unequivocal. The following suggestion puts the insured on notice by spelling out the forms of exhaustion without limiting them:

Our duty to settle or defend ends when our liability for this coverage has been exhausted. Coverage may be exhausted in any manner, including but not limited to the following methods of payment by the Company: to the insured if she consents; to a claimant or claimants in full or partial satisfaction of a settlement of the claimant's or claimants' actions against the insured; to a claimant or claimants in full or partial satisfaction of a judgment against the insured; to a claimant or claimants in return for a release of the Company, whether or not the insured is also released; to the court when there are conflicting claimants and the Company wishes to interplead.

Unlike the *Brown* policy, this language is not ambiguous. Moreover, it notifies the insured that the duty to defend can terminate quickly. Although this Note argues that such a provision is void as against public policy, only the courts can make such a decision.¹⁰⁵ Certainly an insurer can defend its contract more forcefully when it has used explicit language and can argue that it has acted in good faith¹⁰⁶ by making every effort to avoid prejudicing the rights of its insured. Because the LMCC policy language was not explicit, leaving the Browns without warning that LMCC's duty to defend them could end so quickly, the *Brown* court correctly decided to construe the ambiguous language against the defendant. The only mistake the court made was resting its opinion on so vulnerable a basis as ambiguity.

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103. 7C J. APPLEMAN, *supra* note 83, § 4682, at 36 (1979).

104. It was not the intent of the drafters of the 1966 and earlier policies to give the insured a valueless right. According to several representatives of the insurance industry, the purpose of the 1966 addition of "by payments of judgments or settlements" was merely to clarify the defense coverage clause, not to change its substance. Van Vugt, *supra* note 28, at 263. Therefore, "it could be persuasively argued that under all forms of the standard liability policy exhaustion of policy limits can occur only by payment of judgments or settlements." *Id.* If this is indeed the intent of the drafters, then they always have meant for the insured to obtain something of value. Of course, the argument on the other side is what the dissent in *Brown* asserted: that the drafters of the *Brown* policy, which omits the language added in 1966, did not intend to limit exhaustion to settlement or judgment. *Brown*, 326 N.C. at 399, 390 S.E.2d at 157 (Whichard, J., dissenting).

105. Moreover, there is significant support for the position that when the contract makes the option clear, payment of coverage limits into court is not against public policy. Several courts have upheld this form of exhaustion. *E.g.*, Commercial Union Ins. Co. v. Adams, 231 F. Supp. 860, 866 (S.D. Ind. 1964); National Union Ins. Co. v. Phoenix Assurance Co., 301 A.2d 222, 225 (D.C. 1973); Batdorf v. Transamerica Title Ins. Co., 41 Wash. App. 254, 702 P.2d 1211, 1213 (1985).

106. For an argument that insurers can exhaust policy limits in all cases with multiple claimants by interpleading, so long as they do so in good faith, see Zulkey, *supra* note 99, at 204-05.