

The Tripartite Relationship in Insurance: Ethical Dilemmas and Coverage Complexities

Strategies to Navigate the Conflicts of Interest Minefield

A Live 90-Minute Audio Conference with Interactive Q&A

Today's panel features:

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Tuesday, May 5, 2009

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The Tripartite Relationship in Insurance: Ethical Dilemmas and Coverage Complexities

Strategies to Navigate the Conflicts of Interest Minefield

A Live Interactive 90-Minute Teleconference Program
Tuesday, May 5, 2009

1:00 p.m. Eastern Time / 12:00 p.m. Central Time /
11:00 a.m. Mountain Time/ 10:00 a.m. Pacific Time

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The tripartite relationship and the ethical concerns that follow are of top concern to insurance counsel. The parties of the tripartite relationship are in a unique situation that requires them to tread carefully. Failure to do so can prove costly.

Counsel retained by an insurance company to represent a policyholder faces the dual client dilemma, which raises many difficult issues. While the interests of the policyholder and insurer are similar, there are no problems. However, when these interests are not aligned, conflicts of interest arise and coverage may be impacted.

This teleconference will examine the conflicts of interest and ethical problems faced by the three parties, the coverage implications of the tripartite relationship, how the courts and state bars address the issues, and strategies for navigating the minefield of potential conflicts of interest.

- I. Conflicts of interest
 - A. Reservation of rights
 - B. Claimed damages exceed coverage
 - C. Representation of multiple parties
 - D. Defense costs reduce available coverage
 - E. Punitive damages
 - F. Insurer tries to reduce expense by limiting discovery
 - G. Disclosures to the insurer
 - H. Policyholder's failure to cooperate
 - I. Control of settlement

- II. Coverage implications
 - A. Managed litigation practices/procedures
 - B. Use of defenses – only token defense?
 - C. Steering result to judgment under an uninsured theory of recovery
 - D. Later use of confidential information by insurer to its advantage
 - E. Settlement

- III. Ethical rules and the state of the law
 - A. Ethical rules
 - B. State statutes
 - C. Court treatment
 - D. State bar associations

- IV. Strategies for navigating conflicts of interest
 - A. Engagement letter
 - B. Additional counsel at policyholder's expense when claim or suit is in excess of limits
 - C. Inform policyholder/additional counsel of all settlement negotiations/pertinent information
 - D. Inform policyholder/additional counsel of counterclaims

Assessing Conflicts of Interest in the Tripartite Relationship

By Laura A. Foggan and Elizabeth Eastwood

October 1, 1997

The “tripartite” relationship refers to the relationship among the three parties when a lawyer is hired by an insurer to defend a suit against its policyholder. That multifaceted relationship can present actual or potential conflicts between the interests of the insurer and insured. This article reviews the sources of law governing whether a conflict exists and a series of scenarios that may pose actual or potential conflicts between the interests of the insurer and its policyholder. We also discuss how these issues may arise in the particular context of environmentally related liability and coverage cases.

A variety of sources of law should be consulted in determining whether a conflict exists in the tripartite relationship when a lawyer is hired by an insurer to defend a suit against its policyholder. In particular, state statutes, the insurance contract itself, insurance case law, standards of professional ethics for attorneys, or some combination of these may provide important guidance in determining whether any true conflict of interest exists.

State Statutes

A few states—Alaska, California, and Florida—have enacted statutes that address when a conflict of interest exists between an insurer and its policyholder with respect to the defense of an underlying lawsuit.

The California statute provides that a conflict of interest “may” exist, “when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim”¹ The statute explicitly provides that a conflict of interest does *not* exist as to (1) allegations or facts in the litigation for which the insurer denies coverage; (2) claims for punitive damages; or (3) claims for damages in excess of the insurance policy limits. If a conflict does exist, the statute requires the insurer to “provide independent counsel to the insured,” unless the insured waives, in writing, the right to independent counsel after disclosure of the conflict.²

Unlike the California statute, which draws distinctions between situations that do give rise to conflicts of interest and those that do not, Florida’s Claims Administration statute assumes a conflict of interest between the insurer and the policyholder whenever the insurer asserts a coverage defense. When the insurer does assert a coverage defense, the statute requires the insurer either to (1) obtain a nonwaiver agreement from the policyholder, after “full disclosure of the specific facts and policy provisions upon which the coverage defense is asserted and the duties, obligations, and liabilities of the insurer during and following the pendency of the subject litigation”; or (2) retain “independent counsel which is mutually agreeable to the parties.”³

Cases applying the Florida Claims Administration Statute have held that the term “coverage defense” as used in subsection (2) means only a “defense to coverage that otherwise exists and does not include disclaimer of liability based on complete lack of coverage for loss sustained.”⁴

The Alaska statute, which became effective on July 1, 1995, bears substantial resemblance to the California statute. Like the California statute, the Alaska statute provides that a conflict of interest is not created by (1) a claim for punitive damages; (2) a claim for damages in excess of the policy limits; or (3) claims or facts in a civil action for which the insurer denies coverage. The statute further states, however, that (c) Notwithstanding (b) of this section, if the insurer reserves the insurer’s rights on an issue for which coverage is denied, the insurer shall provide independent counsel to the insured⁵

Other states have considered proposed legislation to govern when a conflict of interest exists between an insurer and its policyholder that entitles a policyholder to representation by independent counsel. For example, the Washington state legislature has considered a bill, opposed by the insurers, that which would create an absolute policyholder right to select independent counsel to defend it at its insurer’s expense whenever an insurer reserves its rights to contest indemnity coverage for an environmental claim.⁶

If the approach is even-handed legislation governing the existence of conflicts of interest and the necessity for independent counsel can benefit everyone. A statute that provides clear guidance as to what constitutes a conflict of interest giving rise to a need for independent counsel, and which fairly takes into consideration the legitimate interests of both policyholders and insurers, can eliminate uncertainty and reduce litigation between insurers and their policyholders over these issues.

The Insurance Contract Itself and Insurance Case Law

Obviously, a direct source of the mutual rights and obligations of the insurer and its policyholder is the insurance contract. Many insurance contracts are silent on what constitutes a conflict of interest between the insurer and the policyholder, or what impact such a conflict of interests has on the insurer’s contractual rights relating to the defense of suits against the policyholder. Some insurance contracts minimize the potential for conflicts of interest in the tripartite relationship. For example, defense reimbursement policies under which the policyholder controls its own defense but defense costs reduce the limit of liability sidestep much of the potential for conflicts of interest in the defense of the underlying action. There may still be disagreement—and potential conflict—on issues such as the selection of counsel and settlement, however.

Nevertheless, most insurance contracts at least set out the insurer’s right to control the defense and settlement of suits against the insured or to designate counsel to defend the policyholder. For example, general liability and automobile liability policies often expressly endow the insurer with the unqualified right to “defend any suit against the insured” seeking damages on account of bodily injury or property damage to which the policy applies, and to “make such investigation and settlement of any claim or suit as it deems expedient...”

Notwithstanding the insurer’s unqualified contractual rights under the policy, both courts and legislatures have engrafted limitations on the insurer’s involvement in the policyholder’s defense

where there is a conflict of interest between the insurer and its policyholder.⁷ Some courts addressing this issue have explicitly suggested that the insurance contract itself should speak to the conflict of interest problem.⁸

In many jurisdictions there is substantial case law specifically addressing what constitutes a conflict of interest between an insurer and a policyholder, and what consequences flow from the existence of such a conflict. Even when there is no authority squarely addressing the conflict issue, guidance may be offered by insurance case law on related topics, including the application of the “common interest” doctrine and other issues surrounding the disclosure of information relating to underlying claims.

Standards Governing Professional Ethics of Attorneys

Guidance on insurer-policyholder conflict of interest issues is also afforded by standards governing the professional ethics of attorneys, which are found in sources including the Model Code of Professional Responsibility, the Model Rules of Professional Conduct, state-specific ethics rules, ethics opinions, and the Restatement (Third) of the Law Governing Lawyers (Proposed Final Draft No. 1, March 1996). Case law relating to attorney malpractice and attorney disqualification may also be relevant.

Many sources on attorney professional ethics provide guidance to insurers by way of analogy because they focus on the attorney-client relationship rather than the insurer-policyholder relationship. Model Rule 1.7 does include two comments that directly address the tripartite relationship. In discussing situations in which a party other than the client pays the attorney, one comment states that “when an insurer and its insured have conflicting interest in a matter arising from a liability insurance agreement, and the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel’s professional independence.”

A second relevant comment addressing the duties of independent counsel states that “[t]he representation of an insured by the insurance company’s lawyer also presents a potential conflict of interest. For example, problems arise when a course of action would be beneficial to the client-insured but would be detrimental to the insurer that employs or pays the lawyer. The Comment to Rule 1.7(b) states that while a lawyer’s fee may be paid by a source other than the client, the client must be informed of that fact and must consent . . . Rule 1.7 requires that the arrangement not compromise the lawyer’s duty to loyalty to the client.”⁹

The Restatement (Third) of the Law Governing Lawyers may also have a direct application to these issues. Although the Restatement has not yet been finalized, drafts of the document have included specific, and highly controversial, comments concerning the tripartite relationship that arises when a lawyer is hired by an insurer to defend a suit against its policyholder.

Common Situations Giving Rise to Potential Clients

A host of situations may pose actual or potential conflicts between the interests of the insurer and its policyholder, and, in some of these situations, courts have explicitly concluded that independent counsel must be afforded to the insured. Examples of common areas where conflicts may arise are reviewed below, together with observations about whether they call for the use of

independent counsel to protect the interests of the insureds. Several situations that may arise in cases involving coverage for environmental liabilities are highlighted.

Insurer Covers Multiple Insureds with Adverse Interests

In many cases an insurer will have a duty to defend two insureds whose interests are adverse to each other, and may be adverse to the insurer. The classic illustration of this situation is in the context of auto liability insurance. For example, in *Murphy v. Urso*, 430 N.E.2d 1079 (Ill. 1981), a passenger injured in an auto accident filed suit against the driver and the owner of the vehicle, and an issue existed as to whether the driver had permission to use the vehicle. The driver's interests conflicted with those of the owner, and with those of the insurer, because the driver would not be insured under the owner's policy unless he was operating the vehicle with permission. Under these circumstances, the Illinois Supreme Court held that the conflicts of interest prevented the insurer from controlling the defense of the driver. 430 N.E.2d at 1085.

It is also relatively common for two drivers who are involved in an accident, and who by coincidence are insured by the same carrier, to sue one another, thus triggering the insurer's duty to defend each against the other. In this situation the insurer is not permitted to control the defense of either policyholder, and must retain independent counsel for each.¹⁰

Of course, the problem of multiple insureds whose interests conflict is not limited to the auto liability context.¹¹ When the interests of multiple insureds conflict with one another, by definition the insurer cannot share all interests in common with each of its policyholders. In this situation, the insurer may be required to provide not only separate, but independent counsel for its insureds.

In environmental cases, there are several contexts where an insurer may have multiple insureds – sometimes with adverse interests – involved in the same claim. A claim may arise due to activities of a subcontractor or lessee that is an additional insured under the policy of an insured that is also named in the suit. Alternatively, multiple policyholders may be sued for cleanup at the same site, perhaps with different types of responsibility for the loss. For example, an insurer may have issued coverage to a site owner-operator, as well as to a generator or transporter of hazardous waste. In these cases, if a defense obligation exists, it is necessary for the insurer to ensure that the defense is conducted consistent with the interests of each insured.

Coverage not Disputed, but Policyholder's Exposure Exceeds Limits

Claims for damages in excess of the applicable policy limits raise the potential for a conflict of interest between an insurer and its policyholder. This is true because the insurer and policyholder may take opposing views as to whether and when a claim should be settled. The policyholder will usually prefer to have a case settled quickly and within policy limits to minimize any possibility of an excess judgment. The insurer, whose exposure is capped at its policy limits, may prefer to try the case, or to attempt to negotiate a more favorable settlement than that initially offered by the claimant.¹²

The fact that a policyholder's exposure in a given suit exceeds the coverage limits, standing alone, generally will not entitle the policyholder to representation by independent counsel.^{13 14} Instead, courts often give the insurer an additional incentive to consider its policyholder's

interests in settlement by allowing the policyholder to recover against the insurer where the latter's bad faith (or in some jurisdictions merely negligent) refusal to settle within limits ultimately results in an excess judgment against the policyholder.

Because environmental cleanups are often costly and because a responsible party can often be held jointly and severally liable for the entire cost, hazardous waste related actions frequently involve the potential for an excess verdict. As noted above, the potential of excess liability above the indemnity limits of a defending primary insurer will not—standing alone—create a conflict requiring independent counsel.

Coverage not Disputed, but Policyholder Has Large Deductible

Where the policyholder has a large deductible, the incentives discussed previously may be reversed—under these circumstances, a potential conflict exists because the insurer might prefer to settle for an amount within, or close to, the deductible while the policyholder might prefer to try the case in the hope of avoiding liability altogether. This potential conflict, however, generally does not entitle the policyholder to independent defense counsel.

Moreover, where the relevant insurance contract explicitly entitles the insurer to make any settlement it deems expedient, courts generally uphold the insurer's right to settle, notwithstanding its policyholder's objection, even when the settlement will require the policyholder to pay large deductible amounts.¹⁵ Still, a minority of courts, have held that where a substantial deductible is involved, the insurer must obtain the policyholder's consent to settlement,¹⁶ even in the absence of policy language imposing such a requirement.¹⁷ However, even these courts have not suggested that the existence of a large deductible, standing alone, entitles the policyholder to representation by independent counsel.

Coverage not Disputed, but Insurer Sharply Restricts Defense Expenditures

The interests of the insurer and its policyholder may also conflict “when the insured expects the best possible defense and the insurer expects a cost-effective defense.”¹⁸ As one commentator points out, extreme cost containment measures imposed by insurers may expose the insurer to bad faith liability—and the defense counsel to malpractice liability – for inadequate defense preparation and trial presentation.¹⁹

Douglas Richmond, “The Tripartite Relationship Between Insurer, Insured and Insurance Defense Counsel.” 73 Neb. L. Rev. 265 (1994), has observed that the opposite problem can arise if an insurance policy gives the insurer the right to control the defense but provides that defense costs reduce the policy limit.

Mr. Richmond states that in this situation, “[a]n insured is potentially prejudiced every time her appointed counsel acts, since every dollar the attorney earns in fees reduces the available coverage.”²⁰ Richmond therefore opines that in such cases, “insureds must always be timely informed of defense expenditures and the amount of remaining coverage.”²¹ This situation is not likely to arise very frequently, however, because most insurance policies that contain defense-in-limits provisions require the insurer to reimburse the policyholder's defense costs rather than giving the insurer the right to control the policyholder's defense. Further, even Mr. Richmond

does not assert that the conflict he describes should require that the insured be afforded independent counsel subject to only the policyholder's control of the defense.

The potential for conflict caused by cost-containment efforts plainly does not entitle the insured to independent counsel, however. Indeed, it is clear that the insurer need only pay reasonable fees of defense counsel, even when independent counsel is required.

Some environmental cases may be candidates for disputes over the necessity of expansive defense expenditures. For example, an insured may wish to obtain advice or testimony from multiple consultants on issues relating to liability or a cleanup plan. The question of whether the fees for such scientific testimony are necessary and reasonable can prompt disputes between the policyholder seeking a "gold-plated" defense and the insurer seeking to impose reasonable constraints on costs and attorney's fees.

Coverage Not Disputed, But Insurer and Policyholder Disagree on Manner in Which Defense Should Be Conducted

A policyholder will occasionally contend that a conflict of interest exists between itself and its insurer because the two disagree at the outset—as a matter of judgment not tied to any objective conflict of interest—as to how the underlying claim should be defended. Where the insurance contract expressly gives the insurer the right to control the defense, courts usually enforce that right, but a policyholder may be entitled to independent counsel where the insurer proposes to handle the defense in a manner that could severely harm the policyholder (*e.g.*, if it would put the policyholder out of business).

In *Roussos v. Allstate Insurance Co.*, 655 A.2d 40, 44 (Md. Ct. Spec. App.), cert. denied, 663 A.2d 73 (Md. 1995), one court has explicitly refused "to extend an insurer's duty to provide independent counsel to a situation where the insured merely disagrees with the manner in which he or she is being defended." In *Roussos*, the policyholder challenged her insurer's right to control the defense of a personal injury action arising from an auto accident. The insurer believed the policyholder was likely to be found liable and wanted to settle the action expeditiously, while the policyholder, who believed that she had been sued unjustly and wished to maintain her clean driving record, opposed settlement. Based on this disagreement, the policyholder contended that she was entitled to be represented by counsel of her own choosing, at the insurer's expense. Rejecting this argument, the Maryland Court of Special Appeals reasoned that "[a]lthough these objectives are not identical, they are simply not adverse."²² The *Roussos* court also rejected the policyholder's arguments that she was entitled to representation by independent counsel because (1) the claimant sought damages in excess of her policy limits; and (2) she and the insurer were adversaries in two proceedings before the state insurance commission regarding the amount of coverage provided by her policy.²³ The court further stated that "[a]n insurer's right to control the litigation against its insured is essential to protect the insurer's financial interest in the outcome of the suit."²⁴

A disagreement concerning defense strategy may entitle a policyholder to separate counsel, however, where the insurer's proposed course of action could result in severe adverse consequences to the policyholder. For example, in *69th Street and 2nd Ave. Garage Associates, L.P. v. Ticor Title Guarantee Co.*, 622 N.Y.S.2d 13, 14 (App. Div., 1st Dept.), appeal denied,

661 N.E.2d 999 (N.Y. 1995), a New York appellate court held that a policyholder was entitled to counsel of its own choosing where the policyholder and the insurer disagreed on defense strategy, and where the continued viability of the policyholder's business arguably depended on a quick resolution of the underlying suit, whereas the insurer could afford to proceed at a "leisurely" pace. The court stated as follows:

The interests of Garage Associates and Ticor diverged seriously here, though each wished to defeat the claim of the cond-op. Ticor, having insured the title of a heavily mortgaged property, could proceed leisurely. Garage Associates needed a quicker resolution to keep open the possibility of refinancing, to retain customers and employees, and to stay in business. There was a crucial conflict of interests between them, and Garage Associates had the right to its own attorneys.²⁵

The court acknowledged that the insurance contract entitled the insurer to control the policyholder's defense, but concluded that the insurer's right was "overridden" by the policyholder's right to independent counsel in a conflict of interest situation.²⁶ Although most courts enforce the insurer's contractual right to control its policyholder's defense, a few courts will "override" if the stakes which rest on the contested defense strategy are high enough for the policyholder.

Coverage Not Disputed, But Policyholder Opposes Settlement (*e.g.*, Due to Reputational Damage)

Some cases raise the potential for conflicts in the resolution of the claim because the policyholder, fearing damage to its reputation or some similar harm, opposes any settlement, even a settlement completely within policy limits.²⁷

Courts typically have not treated this situation as creating a conflict of interest that entitles a policyholder to separate counsel. Indeed, at least where the insurance policy gives the insurer the right to make any settlement that it deems expedient and does not expressly require the insurer to obtain policyholder's consent to settlement, courts generally uphold an insurer's decision to settle even over its policyholder's objections.²⁸

Where the insurance contract at issue is silent as to whether the insurer has the exclusive right to settle, however, an insurer may be required to obtain the policyholder's consent before settling, even if the proposed settlement amount would fall entirely within the policy limits.²⁹

Underlying Complaint Seeks Punitive Damages

A conflict of interest between an insurer and its policyholder may also be found to exist when the underlying complaint against the policyholder seeks punitive damages and the insurance policy expressly excludes coverage for punitive damages, or the relevant jurisdiction prohibits insurance coverage for punitive damages on public policy grounds. In this situation, some courts believe that independent counsel is required because the insurer may not have a sufficient incentive to defend vigorously against the punitive damage claim.

Treatment of this situation varies among jurisdictions. As noted earlier, California Civil Code § 2860 explicitly provides that a claim against the insured for punitive damages, standing alone,

does not entitle the insured to independent counsel at the insurer's expense. The same is true of the applicable Alaska statute. Alaska Stat. § 21.89.100(b)(1).

On the other hand, in *Nandorf, Inc. v. CNA Insurance Cos.*, 479 N.E.2d 988, 992 (Ill. App. 1st Dist. 1985), an Illinois appellate court held that independent counsel was required where the insured was sued for a relatively small amount of compensatory damages and a much larger amount of punitive damages.³⁰ The *Nandorf* court stated, however, that it did not intend "to imply that an insured is entitled to independent counsel whenever punitive damages are sought in the underlying action."³¹ The court reasoned that independent counsel was necessary in the case before it because punitive damages formed a substantial portion of the policyholder's potential liability, such that the insurer's disclaimer of coverage for punitive damages "left Nandorf with the greater interest and risk in the litigation."³²

It is possible that a private action seeking recovery for environmental harm might seek modest compensatory damages but substantial punitive damages. As it is in other claim contexts, this scenario is likely to be fairly rare in hazardous waste settings. However, there may be other scenarios in environmental cases where the bulk of the policyholder's potential liability is uninsured. In a Superfund cleanup action, for example, an insured may face uninsured injunctive or equitable relief, perhaps combined with more modest exposure for the insured damages. In such a setting, the policyholder may contend that it should have the ability to influence defense strategy.

Insurer Disputes Coverage and Reserves Rights

Conflict of interest questions most frequently arise in situations where the insurer has a duty to defend the policyholder, but disclaims (in whole or in part) a duty to indemnify based on one or more coverage defenses. The issuance of a reservation of rights as to indemnity coverage is characteristic of most environmental coverage cases today. This is true because of the widespread use of pollution exclusions, the coverage issues relating to the nature of relief sought in cleanup cases (for example, whether cost-recovery claims seek insured "damages"), the potential for environmental harm that is expected or intended because it results from routine business practices, and a host of other coverage issues that are not unique to the environmental setting (for example, late notice, voluntary payments, and so forth). Courts and legislatures in some jurisdictions have determined that a policyholder is entitled to representation by independent counsel whenever the insurer issues a reservation of rights. Courts and legislatures in other jurisdictions, however, have declined to adopt such a *per se* rule and instead determine whether independent counsel is necessary based on (1) whether the insurer would be able to direct the insured's defense in a manner adverse to the insured on the disputed coverage issue; and/or (2) which party, insurer or insured, bears the greater financial stake in the underlying litigation.

The following jurisdictions appear to have adopted a *per se* rule that the policyholder is entitled to independent counsel whenever an insurer issues a reservation of rights:

Alabama: *L & S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1303 (Ala. 1987) (adopting holding of Washington Supreme Court that insurer defending under

reservation of rights is subject to an “enhanced obligation of good faith,” which includes an understanding that defense counsel’s only client is the insured)

Arizona: *United Services Auto. Assoc. v. Morris*, 741 P.2d 246, 251-52 (Ariz. 1987) (en banc) (“[t]he insurer’s reservation of the privilege to deny the duty to pay relinquishes to the insured control of the litigation”)

Florida: F.S.A. § 627.426(1)(b)3 (West 1996) (absent non-waiver agreement, when insurer reserves rights, insured is entitled to “mutually acceptable” independent counsel)

Kentucky: *Medical Protective Co. v. Davis*, 581 S.W.2d 25, 26 (Ky. App.), review denied (Ky. Ct. 1979) (when insurer offers defense under reservation of rights, “the insured has the right to refuse the proffered defense and conduct his own defense”)

Louisiana: *National Union Fire Ins. Co. v. Circle, Inc.*, 915 F.2d 986, 991 (5th Cir. 1990) (Louisiana law) (insurer that reserves rights discharges contractual obligation to defend by engaging separate counsel to represent insured); *Dugas Pest Control of Baton Rouge, Inc. v. Mutual Fire, Marine and Inland Ins. Co.*, 504 So. 2d 1051, 1054 (La. Ct. App. 1st Cir. 1987) (“[i]f insurer chooses to represent the insureds but deny coverage, it must employ separate counsel”)

Massachusetts: *Three Sons, Inc. v. Phoenix Ins. Co.*, 257 N.E.2d 774, 776-77 (Mass. 1970) (insured did not breach duty to cooperate by refusing to accept insurer’s defense under reservation of rights)

Missouri: *State Farm Mut. Auto Ins. Co. v. Ballmer*, 899 S.W.2d 523, 526 (Mo. 1995) (en banc) (insured has the right to reject defense under reservation of rights); *Butters v. City of Independence*, 513 S.W.2d 418, 424-25 (Mo. 1974) (same)

Texas: *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120 (5th Cir. 1983) (Texas law) (when insurer proposes to defend under reservation rights, insured may refuse insurer’s offer and pursue his own defense, and insurer remains liable for insured’s attorneys’ fees); *Britt v. Cambridge Mutual Fire Ins. Co.*, 717 S.W.2d 476, 481 (Tex. App., San Antonio 1986) (same); *Western Casualty & Sur. Co. v. Newell Manufacturing Co.*, 566 S.W.2d 74, 76 (Tex. Civ. App., San Antonio) (if insured refuses insurer’s offer to defend under reservation of rights, “insurer cannot stubbornly continue with the defense and still preserve its right to assert policy defenses”) (citations omitted), writ ref’d n.r.e., (Sept. 20, 1978).

Washington: *Tank v. State Farm Fire & Casualty Co.*, 715 P.2d 1133, 1137 (Wash. 1986) (en banc) (when defense is provided under reservation of rights, insurer’s enhanced obligation of good faith requires recognition that “only the insured is the client” of retained defense counsel)³³

Jurisdictions that have appear to have adopted a fact-dependent test for determining the necessity of independent counsel include **California, Illinois, New York, Ohio, Oklahoma** and **Pennsylvania**.

The applicable California statute provides that the policyholder may have a right to independent counsel when “insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim.” Cal. Civ. Code § 2860(b) (emphasis added). Thus, by implication, an insurer’s reservation of rights might not entitle the policyholder to independent counsel if defense counsel would not be able to manipulate the outcome of the coverage issue.

The New York Court of Appeals took a similar approach in *Public Service Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810 (N.Y. 1981). The *Goldfarb* court concluded that independent counsel would be required only when the defense attorney’s duty to the insured would require a defense on any grounds, but his duty to the insurer would require a defense only on those grounds that would defeat insurer liability. As an example of a case of covered and non-covered claims that would not create the necessity for independent counsel, the *Goldfarb* court offered a hypothetical case in which the policy covered only personal injury, but the policyholder was sued for personal injury and property damage. The *Goldfarb* court reasoned that separate counsel would not be necessary because the question of coverage would not be connected with the question of the insured’s liability.³⁴

Illinois courts have taken a similar view. In determining whether a conflict of interest creating a right to independent counsel exists, Illinois courts consider “whether, in comparing the allegations of the complaint to the policy terms, the interest of the insurer would be furthered by providing a less than vigorous defense to those allegations.”³⁵ According to these courts, an insurer’s interest in negating coverage does not, standing alone, create a sufficient conflict of interest to prevent the insurer from assuming control of its policyholder’s defense; such a conflict may exist, however, when an underlying action asserts claims that are covered as well as claims against which the insurer has a duty to defend but asserts are not covered by its policy. *Illinois Masonic*, 522 N.E.2d at 614; *Nandorf*, 479 N.E.2d at 992.

Federal courts applying Pennsylvania law have also concluded that an insurer’s reservation of rights does not always entitle the policyholder to representation by separate counsel. *Pennbank v. St. Paul Fire and Marine Ins. Co.*, 669 F. Supp. 122, 126-27 (W.D. Pa. 1987); *St. Paul Fire & Marine Ins. Co. v. Roach Brothers Co.*, 639 F. Supp. 134, 139 (E.D. Pa. 1986) (existence of both covered and non-covered claims raises potential for conflict, “but actual conflict is not inevitable”). The court acknowledged that independent counsel would be required in a situation where an insurer could be “tempted to construct a defense which would place any damage award outside policy coverage,” but it concluded that separate counsel was not necessary merely because punitive damages, for which the insurer denied coverage, were sought against the policyholder. The court reasoned that such a danger did not exist in this case because findings against the insured that would support an award of punitive damages also would “guarantee a large award of compensatory damages.”

New Jersey takes a unique approach to the independent counsel issue. Under New Jersey law, an insurer cannot defend its policyholder if (1) the trial will leave the question of coverage unresolved so that the policyholder may later be called upon to pay; or (2) the case may be so defended by a carrier as to prejudice the policyholder thereafter on the issue of coverage. Where a conflict prevents an insurer from assuming the defense of its policyholder, the insurer is not

obligated to provide ongoing funding for the policyholder's defense. Instead, under *Burd*, [*Burd v. Sussex Mut. Ins. Co.*, 267 A.2d 7, 10 (N.J. 1970)] the insurer's duty to defend is translated into an obligation "to reimburse the insured if it is later adjudged that the claim was one within the covenant to pay." *Burd*, 267 A.2d at 10 (emphasis added).

Further, in *Trustees of Princeton University v. Aetna Casualty & Sur. Co.*, ___ A.2d ___ [1996 WL 471008 at 6] (N.J. Super. Ct., App. Div. Aug. 14, 1996), a New Jersey appellate court held very recently that a policyholder may not escape the operation of the *Burd* rule and require an insurer to defend it by offering to sign a non-waiver agreement, at least "where the circumstances are conflict-laden with concerns about the insured's intent" and the prospective waiver of any conflict might be unenforceable.

There is one very common set of facts that is almost certain to give rise to an independent counsel requirement, even in jurisdictions that do not apply a *per se* rule -- if an underlying complaint alleges mutually exclusive theories of recovery (such as negligence and intentional tort), some of which would be covered under the policy and some of which would not. Courts addressing the situation have generally concluded that separate representation for the policyholder is necessary.³⁶

Courts have found a conflict of interest where the underlying complaint alleges both negligence and intentional torts (or some other set of mutually exclusive covered and non-covered theories of recovery) because of the danger that an insurer might deliberately defend the policyholder in a manner that would result in a finding of liability only on non-covered claims. Under the fact-dependent approach to determining conflicts adopted in states such as California and New York, only this type of situation is deemed to raise a conflict of interest sufficient to require independent counsel for the policyholder. In contrast, courts adopting *aper se* rule that a policyholder is entitled to independent counsel any time an insurer reserves its rights have reasoned that the insurer's contractual right to control the defense of suits against its policyholder presupposes that the insurer will pay any judgment resulting from such suits, and that where the duty to pay the judgment may fall on the policyholder instead of the insurer, the right to defend should also belong to the policyholder.

Conclusion

It is often difficult to determine whether there exists a true conflict between an insurer's interests and those of its policyholder such that independent counsel will be required. These questions arise in virtually all environmental cases where an attorney is retained by an insurer to defend a suit against its policyholder. The law in this area remains undeveloped on key points in many jurisdictions. Even in states where a *per se* rule has been articulated, there may be room for debate. Many of the cases engendering a broad statement that independent defense counsel must be afforded if a reservation of rights is issued by the insurer involved coverage defenses that were intertwined with issues in the underlying claim. It is unclear whether these states would apply a *per se* rule if a coverage issue wholly unrelated to the underlying claim were at stake. Further, the law governing the independent counsel question is in flux. The Restatement of the Law Governing Lawyers will soon be finalized and will contain new language bearing on this issue. The firestorm of commentary and concern about the proposed Restatement provisions may prompt other efforts to influence this area of the law, particularly in the legislative arena. Given

the uncertain and potentially shifting standards, it is important to consider all relevant sources of law in resolving whether an actual conflict requiring independent counsel exists.

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¹ Cal. Civ. Code §2860(b) (West 1996).

² Id. at §2860(a).

³ Fl. St. Ann. §627.426(2) (West 1996).

⁴ See, e.g., *AIU Ins. Co. v. Block Marina Inv., Inc.*, 544 So.2d 998 (Fla 1989).

⁵ Alaska Stat. §21.89.100(c) (1996).

⁶ S. 6310, 54th Leg., Reg. Sess. (Wash. 1996).

⁷ See, e.g., *Brohawn v. Transamerica Ins. Co.*, 347 A.2d 842 (Md. 1975) (insurer should have provided for contingency that its interests would conflict with those of its policyholder); *Employers Fire Insurance Co. v. Beals*, 240 A.2d 397, 404 (R.I. 1968) (insurer failed to provide any degree of clarity for this contingency when it drafted the insurance contract), abrogated on other grounds sub nom. *Peerless Ins. Co. v. Viegas*, 667 A.2d 785 (R.I. 1995).

⁸ Annotated Model Rules of Professional Conduct, Rule 1.7 (ABA 1992) (citations omitted).

⁹ See, e.g., *O’Morrow v. Borad*, 167 P.2d 483 (Cal. 1946).

¹⁰ See, e.g., *First Insurance Co. of Hawaii v. State*, 665 P.2d 648, 655-56 (Hawaii 1983) (where conflict of interest existed between the policyholder, a public contractor, and an additional insured, the State of Hawaii, insurer could not discharge its duty to the latter by providing counsel to defend the former; separate counsel was required); *Wolpaw v. General Accident Ins. Co.*, 639 A.2d 338, 340 (N.J. Super. Ct., App. Div. 1994) (homeowners’ insurer breached policy by assigning single law firm to represent three insureds with conflicting interests); *Bituminous Ins. Co. v. Pennsylvania Manufacturers’ Assoc. Ins. Co.*, 427 F. Supp. 539, 555 (E.D. Pa. 1976) (where contractor’s interests conflicted with those of subcontractor, and insurer had duty to defend both, insurer was required to provide separate counsel).

¹¹ See, e.g. *Allstate Ins. Co. v. Campbell*, 639 A.2d 652, 659 (Md. 1994) (citing Robert E. Keeton & Alan I. Widiss, *Insurance Law*, § 7.6 (1988) at 815).

¹² See id; Alaska Stat. § 21.89,100(b); Cal. Civ. Code § 2860(b).

¹³ See, e.g., *Campbell*, 639 A.2d at 659; *State Farm Mut. Auto Ins. Co. v. Hollis*, 554 So. 2d 387 (Ala. 1989) (finding jury issue as to whether insurer was negligent in refusing to settle within limits); *Hartford Accident & Indem. Co. v. Foster*, 528 So. 2d 255, 265 (Miss. 1988) (“the insurer has a fiduciary duty to look after the insured’s interest at least to the same extent as its own, and to make a knowledgeable, honest and intelligent evaluation of the claim commensurate with its ability to do so. If the carrier fails to do this, then it is liable to the insured for all damages occasioned thereby”); *Commercial Union Ins. Co. v. Liberty Mutual Ins. Co.*, 393 N.W.2d 161, 164 (Mich. 1986)

("[i]f the insurer is motivated by a selfish purpose or by a desire to protect its own interest at the expense of its insured's interest, bad faith exists, even though the insurer's actions were not actually dishonest or fraudulent"); *Rova Farms Resort, Inc. v. Investors Insurance Co.*, 323 A.2d 495 (N.J. 1974) (where underlying claimant's injury was substantial, and potential liability of insured "should have been reasonably obvious" despite advice of counsel, insurer's failure to offer \$50,000 policy limit was in bad faith and rendered it liable for entire \$225,000 judgment against insured); *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967) (insurer liable for unwarranted rejection of a reasonable settlement offer where it refused a settlement demand within its \$10,000 limit and \$101,000 judgment entered against insured; showing of dishonesty, fraud or concealment on the part of the insurer not required).

¹⁴ See, e.g., *American Home Assurance Co., Inc. v. Hermann's Warehouse Corp.*, 563 A.2d 444 (N.J. 1989) (insurer entitled to reimbursement for deductible amount where insurer settled, over policyholder's objection, for amount substantially in excess of deductible but well within policy limits); *Casualty Ins. Co. v. Town & Country Pre-School Nursery, Inc.*, 498 N.E.2d 1177 (Ill. App., 1st Dist. 1986) (requiring policyholder, which did not approve settlement, to reimburse insurer for \$1800 settlement amount which fell within its \$2000 deductible, despite claims adjuster's belief that policyholder was not liable).

¹⁵ Of course, Fortune 500 companies and other policyholders that choose to bear large deductibles will often negotiate with their insurers for specific contractual provisions that give the policyholder control over settlement of claims likely to fall within the deductible amount.

¹⁶ See, e.g., *Employers' Surplus Line Ins. Co. v. City of Baton Rouge*, 362 So. 2d 561 (La. 1978) (where insurer settled claim for \$75,000 and policy had a \$10,000 deductible, insurer could not recover \$10,000 deductible from policyholder unless policyholder consented to the settlement); see also, *National Service Indus., Inc. v. Hartford Accident & Indem. Co.*, 661 F.2d 458 (5th Cir. 1981) (applying Georgia law) (where insurer proposed to settle claim in a manner that would require policyholder to pay deductible under two policies instead of one, insurer was required to obtain policyholder's consent).

¹⁷ Thomas E. Cooney, "The Perils of Defense Counsel's Relinquishment of Control Over Preparation of the Defense to the Insurer," *Insurance Counsel Journal* (April 1985) at p. 259.

¹⁸ *Id.* at 260-61; see *Kooyman v. Farm Bureau Mut. Ins. Co.*, 315 N.W.2d 30, 35-37 (Iowa 1982) (triable issue as to whether defense counsel's inadequate investigation and trial preparation evidenced insurer's indifference to insured's interests which would establish insurer's bad faith.); cf. *Bevevino v. Saydjari*, 76 F.R.D. 88, 94 (S.D.N.Y. 1977) (refusing insurer's request to set aside unwarranted malpractice verdict against its policyholder where verdict was result of insurer's having "deliberately decided not to provide the [policyholder] with the semblance of a defense"), *aff'd* 574 F.2d 676 (2d Cir. 1978).

¹⁹ 73 *Neb. L. Rev.* at 279.

²⁰ *Id.*

²¹ *Id.*

²² 655 A.2d at 43-44.

²³ *Id.* (citing 7C *Appleman*, § 4681 (1979)).

²⁴ *Id.* at 14.

²⁵ *Id.* at 15.

²⁶ The potential for conflict when a policyholder opposes settlement because of possible reputational harm can be, and frequently is, addressed by an express contractual provision requiring the policyholder's consent to settlement. Such contract provisions often appear in medical malpractice insurance policies, for example.

²⁷ See, e.g., *Western Polymer Technology, Inc. v. Reliance Ins. Co.*, 32 Cal. App. 4th 14, 27 (1st Dist. 1995), review denied, (Cal. Apr. 13, 1995) ("No reasonable reading of [the 'deems expedient' language] would create an expectation that the insurer has to forgo settlement in favor of vindicating the insured's reputation."); *Caplan v. Fellheimer Eichen Braverman & Kaskey*, 68 F.3d 828, 836-37 (3d Cir. 1995) (insurer entitled to settle discrimination claim within limits, over policyholder's objection, even where settlement would prevent policyholder from pursuing its intended malicious prosecution action against discrimination plaintiff); *Savard v. Selby*, 508 P.2d 773 (Ariz. App. 1973) (insurer not liable for settling defamation suit within policy limits, despite alleged adverse impact of settlement on insured's reputation); *Casualty Ins. Co. v. Town & Country Pre-School Nursery, Inc.*, 498 N.E.2d 1177 (Ill. App. 1st Dist. 1986) (affirming insurer's right to settle negligence suit by injured child within policy limits, and over policyholder's objection, despite evidence of claims adjuster's belief that policyholder was not liable); *Olson v. Union Fire Ins. Co.*, 118 N.W.2d 318, 321 (Neb. 1962) (dicta stating that insurer has absolute

authority to settle within policy limits because a policyholder “cannot be injured by a settlement to be wholly paid by the insurer”).

²⁸ See *Saucedo v. Winger*, 915 P.2d 129 (Kan. Ct. App. 1996) (allowing insured to challenge settlement entered into by insurer over its objections, where policy did not give insurer exclusive right to settle).

²⁹ See also, *Illinois Municipal League Risk Management Assoc. v. Seibert*, 585 N.E.2d 1130 (Ill. App. 4th Dist. 1992) (same), appeal denied, 596 N.E.2d 628 (Ill. 1992).

³⁰ 479 N.E.2d at 993.

³¹ *Id.* at 993-94 (emphasis added).

³² Cases holding that a policyholder is entitled to separate counsel whenever an insurer issues a reservation of rights generally do not, but probably should, distinguish between (1) an insurer’s reservation of rights based on a coverage defense that is apparent on the face of the underlying complaint; and (2) an insurer’s reservation of the right to assert any coverage defenses that might later reveal themselves as additional facts are developed. The second situation arguably raises only a speculative potential for a conflict of interest, such that independent counsel should not be required until and unless the insurer actually asserts that a defense to coverage applies.

³³ 425 N.E.2d at 427, n. (emphasis added). See also *Nisson v. American Home Assur. Co.*, 917 P.2d 488, 489-90 (Okla. Ct. App. 1996) (adopting Goldfarb distinction).

³⁴ *Illinois Masonic Medical Center v. Turegum Insurance Co.*, 522 N.E.2d 611, 613 (Ill. App. 1st Dist. 1988) (citations omitted) (policyholder entitled to independent counsel where underlying complaint alleged negligent treatment during one or more of three hospitalizations, one during policy period and two after policy’s expiration); *Nandorf, Inc. v. CNA Insurance Cos.*, 479 N.E.2d 988, 992 (Ill. App. 1st Dist. 1985) (policyholder entitled to independent counsel where complaint sought minimal compensatory damages for which coverage was acknowledged, but substantial punitive damages for which coverage was disputed).

³⁵ *Id.* at 127. See also *Lusk v. Imperial Casualty and Indem. Co.*, 603 N.E.2d 420, 423 (OH. App. 1992) (fact that two insurers reserved rights did not entitle policyholder to independent counsel where policyholder definitely had coverage and dispute was only as to which insurer provided it; conflict entitling policyholder to separate counsel only where insurer’s disclaimer would “render it impossible for such company, in making defense, to protect both its own interests and those of the insured”) (citing *Socony-Vacuum Oil Co. v. Continental Casualty Co.*, 59 N.E.2d 199, 204-205 (Oh. 1945)).

³⁶ See, e.g., *Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620 (8th Cir. 1981) (Missouri law) (policyholder entitled to separate counsel where underlying complaint alleged covered non-willful statutory violation and non-covered willful statutory violation); *Patrons Mut. Ins. Assoc. v. Harmon*, 732 P.2d 741, 745 (Kan. 1987) (policyholder entitled to independent counsel where underlying complaint alleged both negligence and intentional torts); *Public Service Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810 (N.Y. 1981) (independent counsel required where allegations against dentist included both unintentional and intentional injuries); *Thornton v. Paul*, 384 N.E.2d 335, 343 (Ill. 1978) (separate counsel necessary where underlying complaint alleged intentional and unintentional harm); *Brohawn v. Transamerica Ins. Co.*, 347 A.2d 842, 854 (Md. 1975) (policyholder entitled to independent counsel where underlying complaint alleged both negligence and intentional torts); *Burd v. Sussex Mut. Ins. So.*, 267 A.2d 7, 10 (N.J. 1970) (insurer could not defend where underlying complaint alleged negligence and intentional torts); *Employers’ Fire Ins. Co. v. Beals*, 240 A.2d 397, 403 (R.I. 1968), abrogated on other grounds sub nom *Peerless Ins. Co. v. Viegas*, 667 A.2d 785 (R.I. 1995) (policyholder entitled to independent counsel where complaint alleged negligence and intentional torts); *Steel Erection Co. v. Travelers Indem. Co.*, 392 S.W.2d 713, 716 (Tex. Civ. App., San Antonio), writ refused, n.r.e. (Tex. 1965) (insured entitled to counsel of its own selection where insurer disputed coverage, and existence of coverage depended on findings in the underlying action).

A BALANCING ACT: THE TRIPARTITE RELATIONSHIP AND THE ATTORNEY'S ETHICAL OBLIGATIONS

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Introduction

When an insurance company retains counsel to defend its insured in a lawsuit filed by a third party, in most jurisdictions, a “tripartite” relationship between the insurer, the insured, and retained counsel is formed. Upon the initial development of the “tripartite” concept, the insured as well as the insurer were deemed clients of retained counsel. However, evolving statutory and case law has altered the scope of the tripartite relationship. Along the way, courts and ethics committees have deemed that the attorney retained by the insurer owes his primary obligation to the insured. *See, e.g., State Farm Mut. Auto Ins. Co. v. Federal Ins. Co.*, 72 Cal.App.4th 1422, 86 Cal.Rptr.2d 20 (1999).

In the tripartite relationship structure, counsel retained by an insurer to defend its insured must contend with a balancing act of ethical duties to both the insurer who retained him and the insured whom he has been retained to represent. The preliminary ethical issue is whether a conflict exists between the insured, to whom retained counsel owes his primary obligation, and the bill-paying insurer. Additional ethical issues on counsel’s part must be dealt with when a conflict between the insurer and insured arises, including, but not limited to, who controls the defense, to whom information need be imparted, and which member of the tripartite relationship has the final say.

Ethical Rules

In representing their clients, attorneys are charged with abiding by certain established ethical rules. These rules mandate that when an attorney undertakes to represent a client, he must exercise independent judgment, unrestricted by the attorney’s self-interest and by other clients’ interests. An attorney retained by an insurance company to represent its insured begins his representation of the insured with the looming possibility of discordance between his established ethical duty to the insured client and his obligation to the insurer paying his fees. The American Bar Association (“ABA”) has promulgated a myriad of ethical rules under the “Model Rules of Professional Conduct” which may help appointed defense counsel maintain the required balancing act.

Zealous Representation

ABA Model Rule of Professional Conduct, Rule 1.1 defines competence to require legal knowledge, skill, thoroughness, and preparation reasonably necessary for the representation. ABA Model Rule of Professional Conduct, Rule 1.2 provides in pertinent

part that: “A lawyer shall . . . consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client’s decision whether to settle a matter. . . (c) A lawyer may limit the scope of the representation if the limitation is reasonable under the circumstances and the client gives informed consent.”

Maintaining Confidentiality

Among an attorney’s fundamental ethical obligations is the duty of confidentiality to his client. This rule prohibits an attorney from revealing “information relating to representation of a client” unless the client consents after consultation, except for disclosures that are impliedly authorized to carry out the representation. (ABA Model Rules of Professional Conduct, Rule 1.6).

In California Professional Conduct and Formal Opinion Interim Number 96-0012, the State Bar of California Standing Committee on Professional Responsibility and Conduct (“Committee”) considered the existence and scope of an insurance defense counsel’s ethical obligations to the insured when the insurer seeks to obtain the attorney’s file, including communications between the attorney and the insured to which the insurer did not have access. The Committee concluded that the “insurer and insured are joint clients” under California law. Generally, joint clients have “no expectation of confidentiality between themselves concerning the matter on which they are joint clients.” Further, “joint clients usually have an equal right to the attorney’s original file.” The Committee then advised that defense counsel should return to each respective client any papers and property belonging to that client which each client provided to the attorney during representation upon the client’s request.

Avoiding Concurrent Conflicts of Interest

ABA Model Rules of Professional Conduct, Rule 1.7(a) provides that a “concurrent conflict of interest exists if: (1) the representation of one client will be directly adverse to another client; or (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.”

In American Bar Association Formal Ethics Opinion 05-435, the ABA Standing Committee on Ethics and Professional Responsibility Committee (“ABA Committee”) addressed whether under Rule 1.7, a conflict of interest existed when an attorney representing a liability insurer as a named party in a civil lawsuit was concurrently representing a plaintiff in another civil lawsuit against a defendant to whom a defense was being provided under a policy of insurance issued by that liability insurer. The ABA

Committee determined that “representation of the plaintiff was not directly adverse and therefore does not present a concurrent conflict of interest to the lawyer’s representation of the insurer in the other action.” The ABA Committee opined that an attorney’s concurrent representation in unrelated matters of clients whose interests are only economically adverse, does not generally present a conflict of interest requiring his clients’ consent.

Even where there is a concurrent conflict, the Model Rules do allow for a waiver under certain circumstances. Model Rule 1.7(b) permits an attorney to obtain a written waiver from both clients if: “(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.”

Payment of Fees

It is ethically permissible to accept payment of a client’s fees from one other than the client himself with certain restrictions. ABA Model Rules of Professional Conduct, Rule 1.8 (f)(3) states: “A lawyer shall not accept compensation for representing a client from one other than the client unless [the] information relating to the representation of a client is protected as required by Rule 1.6.” Furthermore, Rule 1.8(b) provides that: “a lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client consents after consultation.”

Duty of Independent Judgment

An attorney must not allow the insurer who retains him or her on behalf of an insured to direct or regulate the defense counsel’s professional judgment in the representation. ABA Model Rules of Professional Conduct, Rule 5.4 provides in pertinent part that: “(c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer’s professional judgment in rendering such legal services.”

In Virginia Ethics Opinion Number 1789, the Standing Committee on Legal Ethics (“Standing Committee”) considered a hypothetical question concerning whether a medical record obtained in the course of litigation and submitted in support of the client’s case was part of the client’s file requiring disclosure to the client and whether the insurer and/or medical professional who wrote the report could prevent defense counsel from providing the report to his client. The Standing Committee warned that the “attorney

must be mindful of the fact that he represents the patient, and not the carrier or the psychologist. The attorney should not follow the instruction of these non-clients to breach the duties owed to his client.”

Duty of Attorney to Withdraw From Representation

Model Rule 1.16 provides that “[a] lawyer shall not represent a client or, where representation has commenced, shall withdraw from the representation of a client if: (2) the client persists in a course of action involving the lawyer’s services that the lawyer reasonably believes is criminal or fraudulent; . . . (4) the client insists upon taking action that the lawyer considers repugnant or with which the lawyer has a fundamental disagreement; (5) the client fails substantially to fulfill an obligation to the lawyer regarding the lawyer’s services and has been given reasonable warning that the lawyer will withdraw unless the obligation is fulfilled; (6) the representation will result in an unreasonable financial burden on the lawyer or has been rendered unreasonably difficult by the client; or (7) other good cause for withdrawal exists.”

Tipping the Balance: Conflicts of Interest and the Insured’s Right to Independent Counsel

A conflict of interest necessitating the involvement of independent counsel on the insured’s behalf arises when insurer-appointed defense counsel cannot effectively maintain the required balancing act between his concurrent ethical duties to the insured and the insurer. Those ethical duties include the ones described above, such as, the duty of zealous representation, the duty of loyalty, and the duty to maintain client confidences.

The balancing act may falter in the first instance where a conflict exists because issues in the litigation against the insured have the potential to impact the insurer’s granting or denial of coverage. Another way that the balance may topple is where a conflict develops because it may benefit the interests of the insurer, but not the insured, or the other way around, if defense counsel provides a less-than-vigorous defense to the entire complaint. Each instance is premised on the idea that the necessary balance is non-existent if defense counsel has the ability to maneuver the underlying case to result in findings that could be detrimental to the insured. *See San Diego Navy Fed. Credit Union v. Cumis Ins. Soc., Inc.*, 162 Cal.App.3d 358, 208 Cal.Rptr. 494 (1984).

Reservations of Rights

An insurer’s issuance of a reservation of rights provides one of the fundamental measures for determining whether independent counsel should be retained to defend the insured against a third party’s claims. A third party’s complaint against an insured

frequently alleges more than one claim for relief. Some of those claims may afford the insured coverage under the insurer's liability policy and others may not. While the insurer may not be obligated to indemnify the insured against all of the claims alleged against him, it is generally required to defend its insured against all alleged claims. *See Buss v. Superior Court*, 16 Cal.4th 35, 939 P.2d 766 (1997). The insurer may send a reservation of rights letter to the insured whereby it explains that even though it is providing a defense in the lawsuit, certain claims may not be covered by the terms of the policy. Conflict of interest situations may arise where the insurer has a duty to defend the insured, but reserves the right to disclaim any duty to indemnify based on one or more coverage defenses.

California has enacted a statute which provides that a conflict of interest "may" exist, "when an insurer reserves its rights on a given issue and the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim. . . ." Cal. Civ. Code §2860(b). The statute states that there is no conflict of interest with respect to (1) matters for which the insurer denies coverage; (2) punitive damages claims; or (3) claims seeking damages in excess of the insurance policy limits. Where it is evident that a conflict exists, section 2860 mandates that the insurer must "provide independent counsel after disclosure of the conflict." *Id.* at §2860(a).

Alaska's statute similarly states that a conflict of interest is not created by (1) a punitive damages claim; (2) a claim for damages in excess of the policy limits; or (3) matters for which the insurer denies coverage. Alaska's statute further provides that if the insurer reserves its rights on an issue for which coverage is ultimately denied, the insurer shall provide independent counsel. Alaska Stat. §21.89.100(c).

In contrast, Florida's Claims Administration statute presumes the existence of a conflict with the insured once the insurer asserts even a single coverage defense. In Florida, the insurer must: (1) procure the insured's waiver after "full disclosure of the specific facts and policy provisions upon which the coverage defense is asserted and the duties, obligations, and liabilities of the insurer during and following the pendency of the subject litigation"; or (2) secure "independent counsel which is mutually agreeable to the parties." Fla. St. Ann. §627.426(2).

Other Common Potential Conflicts Inherent in the Tripartite Relationship

Once the threshold issue that the insured is entitled to independent counsel and the insurer is obligated to pay for that appointment is determined, additional issues often arise which impact the insured's defense. These issues include the insurer's promulgation and enforcement of billing guidelines and determining who maintains control of the insured's defense, control of the flow of information, and control of settlement matters.

Billing Guidelines

Insurers often require defense counsel to comply with billing guidelines in an effort to reduce costs and control the scope of the defense being provided to the insured. Issues generally covered in billing guidelines include, but are not limited to, pre-approval of the contemplated defense action, reimbursable costs, requirements for telephonic rather than in-person court appearances, and the amount of time that may be expended on computerized research. The attorney, whose primary duty is to the insured, must determine if the insurer's billing guidelines negatively impact his ability to represent the insured and whether they interfere with his professional judgment. The attorney may best be served by reviewing the insurer's billing guidelines at the beginning of his retention in order to gain an understanding of the insurer's perspective and be prepared to object to the use of guidelines that hamper his representation of the insured.

In addition to advising retained counsel of the tasks for which the insurer will and will not pay, billing guidelines often require the attorney to submit his bills to a third party auditor. State bar associations and the ABA have rendered opinions on this issue which generally provide that since counsel's comprehensive billing annotations undoubtedly contain some privileged information, which could impact coverage decisions of the insurer or possibly support a finding of waiver of the attorney-client privilege or work product protection, counsel should obtain his client's informed consent prior to submitting bills to third-party auditors.

Control of Defense

Where no conflict exists, insurance policies generally state that the defending insurer is entitled to control the insured's defense. Where a conflict does exist, the insurer's contractual right to control the defense is abrogated by its contractual obligation to provide a defense to its insured. *See Handy v. First Interstate Bank*, 13 Cal.App.4th 917, 16 Cal.Rptr.2d 770 (1993).

The statutes enacted in California and Alaska suggest that while the insurer may not control the litigation where independent counsel is retained, the insurer may participate through its own counsel. Alaska Stat. §21.89.100(g) states: "if an insured selects independent counsel under this section, both the counsel representing the insurer and independent counsel representing the insured shall be allowed to participate in all aspects of the civil action." California Civil Code § 2860(f) similarly provides: "where the insured selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation."

Control of Information

The insured and its independent counsel may have a duty to disclose relevant information regarding the litigation against the insured, although the independent counsel may simultaneously be prohibited from disclosing privileged information to the insurer concerning any coverage disputes. For example, Alaska Stat. §21.89.100(e) states: “[i]f the insured selects independent counsel at the insurer’s expense, the independent counsel and the insured shall consult with the insurer on all matters relating to the civil action and shall disclose to the insurer in a timely manner all information relevant to the civil action.” California Civil Code §2860(d) states: “When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action.”

Control of Settlement

Courts have imposed a duty on insurers to consider the insured’s interests at least equally with its own when evaluating a potential settlement. *See, e.g., Merritt v. Reserve Ins. Co.*, 34 Cal.App.3d 858, 110 Cal.Rptr. 511 (1974). The insurer may be held liable for damages in excess of policy limits if it unreasonably fails to accept a settlement within policy limits. *See Id.* at 520.

Independent counsel is ethically required to attempt to minimize the insured’s liability in reaching a settlement of the third-party litigation. Counsel’s ethical obligation may conflict with the insurer’s desire for an evaluation of the merits of the litigation and a recommendation concerning the proposed settlement.

A possible solution is for the insurer to retain its own counsel to “participate in all aspects of the civil litigation.” Alaska Stat. §21.89.100(c); Cal. Civ. Code §2860(f). Doing so would allow the insurer to evaluate any settlement proposal through its separate counsel, thereby also satisfying its good faith obligation to its insured. However, this approach imposes an additional financial burden on the insurer and therefore, its adoption presents obstacles of its own.

Liability of Insured’s Independent Counsel to the Insurer

In certain circumstances, issues arise pertaining to the insurer’s rights against the independent counsel it retains, such as the right to sue for malpractice, fraud, or otherwise assert claims for damages resulting from the manner of defense. In *Assurance Co. of America v. Haven*, 32 Cal.App.4th 78, 38 Cal.Rptr.2d 25 (1995) (“*Haven*”), the Court

held that independent counsel could be liable to an insurer for negligent breach of statutory duty under California Civil Code sections 2860(c) and(f) where independent counsel had failed to provide known, non-privileged information. *Id.* at 88. However, the insurer could not recover from independent counsel on theories of professional or ordinary negligence for failure to investigate, prepare, or perform similar functions regarding a defense or position favoring the insurer. The court in *Haven* held that “*Cumis* counsel is under no duty to the insurer to investigate or make determinations regarding how the case will be handled. It is the insurer’s duty to make its own investigation and determinations, if needed, using, among other sources, the section 2860 information provided by *Cumis* counsel.” *Id.* at 89 (original emphasis).

Conclusion

In the context of the tripartite relationship, it is a difficult task for an attorney to maintain a balance of zealousness in advocacy, exercise independent judgment, and protect the insured’s right to confidentiality in the face of potential conflicts of interest and economic parameters imposed by the insurer. However, equipped with knowledge of applicable case law, statutory authority, and the rules of professional conduct, counsel retained by the insurer to represent the insured possess the necessary means to meet their ethical obligations and maintain the balancing act that is the tripartite relationship.

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INSURANCE *SCRAWL*

by Marc Mayerson

Commentary on the Law of Insurance, the Insurance of Business, and the Business of Insurance

[« Insurers' Duty to Defend their Insureds Against Intentional Torts | Main | Does a Court's \(Reversed\) Disparagement of the Policyholder's Coverage Claim Alone Eviscerate Its Bad-Faith Claim? »](#)

February 10, 2007

Insurers' Duty to Defend their Insureds Against Intentional Torts

The duty to defend undertaken by an insurance company is an essential component of the "peace of mind" coverage provided by liability insurance protection. Given the [breadth with which the duty to defend is ordinarily construed by the courts](#), the defense-cost coverage of a policy is also referred to as "litigation insurance," that is, insurance against the risk and burden of suits brought against the insured. Disputes have raged over whether that litigation insurance applies, however, to suits against the insured alleging an – or only – intentional tort.

In most states, the test for whether an insurer will have a [duty to defend](#) is whether the suit against the insured might eventuate in a judgment covered by the duty to indemnify, that is, the insurance company's obligation to pay for the damages owed by the insured on account of bodily injury, property damage, or wrongful acts. If the claim against the insured permits proof of a covered indemnity claim, the insurer has a duty to defend. Thus, if a "lesser included offense" would be covered by the duty to indemnify, the insurer has the obligation to mount a defense. *E.g.*, *Abrams v. General Star Indem. Co.*, 67 P.3d 931 (Ore. 2003) (conversion claim).

Naturally, if an insurer has a duty to defend where the claim or suit against the insured (only) [might result in a covered judgment](#), the insurer's obligation to defend may apply even though the judgment ends up being uncovered. *E.g.*, *Tanner v. State Farm Fire & Cas. Co.*, 874 So.2d 1058 (Ala. 2003); *Automobile Ins. Co. v. Cook* (N.Y. July 26, 2006). (Note that public policy does not prevent the insurer from having a duty to defend even if that public policy would bar the insurer from indemnifying the insured for its deliberate misconduct. *E.g.*, *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal. 4th 1076 (Cal. 1993).) In this way, the duty to defend is broader than is the duty to indemnify: a claim might need to be defended even if it need not be paid -- or it is uncertain whether initially the claim will need to be paid by the insurance company. *E.g.*, *Fresno Econ. Import Used Cars, Inc. v. United States F&G Co.*, 142 Cal. Rptr. 681, 685 (Cal. App. 1977). (Note if that certainty that there is no duty to indemnify comes into focus from the undisputed facts developed in the underlying case, the insurer may be able to terminate its defense, prospectively. See *Firco Inc. v. Fireman's Fund Ins. Co.*, 343 P.2d 311 (Cal. App. 1959); Mayerson, [Insurance Recovery of Litigation Costs](#), at 1000 & n. 16; see also *Sterlite Corp. v. Continental Cas. Co.*, 458 N.E.2d 338, 344 (Mass. Ct. App. 1983) (holding that an insurer "can, by certain steps, get clear of the duty [to

defend] from and after the time when it demonstrates with conclusive effect on the third party that as a matter of fact -- as distinguished from the appearances of the complaint and policy -- the third party cannot establish a claim within the insurance," but that "[w]hat is not permitted is that an insurer shall escape its duty to defend the insured against a liability arising on the face of the complaint and the policy by dint of its own assertion that there is no coverage in fact.") .

But what about the situation where the allegations of the complaint, if true, show there is no duty to indemnify and there is no covered lesser-included offense? Insurers typically argue, often with success, that there is no duty to defend such a complaint. *E.g.*, *Farmland Mut. Ins. Co. v. Scruggs*, 886 So. 2d 714 (Miss. 2004). The paradigm case involves allegations of an intentional tort against the insured the essential elements of which negate coverage.

The intentional consequences of an intentional act may still be the basis for coverage, where the legal consequences are not anticipated by the insured. The Illinois Court of Appeal addressed a recurring fact pattern recently, where a contractor cut down trees on the wrong property. Finding it "immaterial that the underlying complaint alleges intentional torts," the Illinois court found that the insured did not expect liability for the physical injury of cutting down the trees. *Pekin Ins. Co. v. Miller*, 854 N.E.2d 693, 696 (Ill. App. 2006).

Recently, the Eighth Circuit was called upon to get involved with a domestic love triangle, in which the insured had an affair with someone's wife, and the cuckold filed suit for alienation of affections. The policy provided coverage for "loss," defined as an "accident . . . which results in bodily injury." The insurer conceded that the injury at issue was bodily injury (though without any physical harm being alleged, *cf. Lavanant v. General Accident Ins. Co.*, [595 N.E.2d 819](#) (N.Y. 1992)). The insurer denied coverage, however, on the ground that affairs of the heart (or body) are not accidents or, in this case, that the cuckold's injury was "expected or intended" by the insured.

The Eighth Circuit in [Pins v. State Farm Fire and Cas. Co.](#) (8th Cir. Feb. 8, 2007) analyzed the elements of proof for the tort claim of alienation of affections under the applicable law (South Dakota). The court found that "intent to injure the marital relationship" was the *sine qua non* of the tort. As the court explained, " 'the acts must have been done for the very purpose of accomplishing this result.' " Slip op. at 4 (citation omitted). The policyholder argued that the record was not sufficient to find conclusively that he expected/intended injury; but distinguishing prior authority, the Eighth Circuit found there were no circumstances where an "accidental loss was even arguably possible." Slip op. at 5. The court concluded that proof of the underlying *tort ipso facto* and *ipso jure* meant the injury was expected or intended, holding:

[T]he comfort and consortium injuries alleged by [the husband] were sufficient to state a claim for alienation of affections, and under South Dakota law, [the husband] could not recover on this claim unless he proved that Pins intended to cause those specific injuries. In these circumstances, any 'loss' to [the husband] was 'expected or intended' by Pins and could not be deemed an 'accident.' Therefore, State Farm had no contractual duty to defend.

Slip op. at 5. Put differently, the court found that State Farm issued a homeowner's policy, not a home-wrecker's policy.

The Eighth Circuit's conclusion that there was no duty to defend where the elements of proof by definition negated coverage is consistent with a Tenth Circuit opinion decided two months before, *Notwen Crop. v. American Economy Ins. Co.* (10th Cir. Dec. 1, 2006). The gravamen of the underlying tort in *Notwen* was that trade secrets were misappropriated and the tortfeasor-insured allegedly used corporate and bankruptcy maneuvers to try to shield its misconduct. While recognizing that unintended consequences of an intentional act still may qualify as covered conduct, the court found that the complaint against *Notwen* admitted of no such possibility. Compare *Cincinnati Ins. Co. v. Eastern Atl. Ins. Co.*, 260 F.3d 742 (7th Cir. 2001). As in *Pins*, the policyholder sought to argue that there was a dispute of fact whether it was culpable and that those facts should be aired out in the underlying action – which the insurer should be defending. The Tenth Circuit rejected this argument in part reasoning:

[T]he argument is patently circular, rendering the exclusion of intentional torts from the liability policy meaningless, at least under the circumstances presented here: it asserts, in effect, that a duty to defend against intentional-tort claims excluded under the policy is nevertheless triggered whenever the insured seeks to defend itself (with the insurer's assistance) in a lawsuit alleging intentional-tort claims.

Cf. Evett v. Corbin, 305 S.E.2d 469, 472 (Mo. 1957). While courts are reluctant to confer on insureds the power to compel their insurers to defend solely by their incanting a denial of the allegations, policyholders reasonably do expect their insurers will protect them when they are wrongly accused of torts.

Many insurance-coverage lawyers are familiar with the California Supreme Court's landmark decision in *Gray v. Zurich Ins. Co.*, 419 P.2d 168 (Cal. 1966), but there is a lesser-known companion case to *Gray* decided concurrently that addresses the important issue of insurers' duty to defend against intentional torts. *Lowell v. Maryland Cas. Co.*, 65 Cal.2d 298 (1966). Standard liability policies provide that the insurer will defend an insured "even if such suit is groundless, false or fraudulent." The California Supreme Court in *Lowell* found this "groundless, false or fraudulent" language to be key in giving rise to a reasonable expectation that the insurer will defend a suit that if the allegations were true would not be covered but where the insured also could obtain a defense verdict of non-liability. (This is different from an insured not being liable for intentional injury but being held liable of the lesser-included offense of negligently caused injury.) So long as there was a substantial basis for the insured's contention of non-liability, the insurer is required to defend:

The insured could reasonably expect that the insurer would furnish him a defense against the "groundless" charge that the insured had committed an assault and battery against the third party. The insured would not expect that the insurer could avoid the obligation of defense on the ground that such obligation covered only "accidents" which were indemnifiable under the policy and that an assault and battery was not such an indemnifiable "accident." The policy promised a

defense "even if [the third party] suit is groundless."

65 Cal. 2d at 301. *Lowell* was in some regards an easy case because the insured obtained a defense verdict in the tort case and the policy expressly afforded defense to "groundless, false or fraudulent" claims; the exclusion for assault and battery did not apply (since the insured was found "not guilty"). See *Travelers Ins. Co. v. North Seattle Christian and Missionary Alliance*, 650 P.2d 250, 254 (Wash. 1982). Thus, given that *Lowell* was -- if defense were not granted -- an insured who would be left with a gap in coverage for defense costs that inured to the insurer's benefit (by avoiding a potentially larger loss or a change in the course of the mounting of the successful defense, cf. [Arenson v. National Auto. & Cas. Ins. Co.](#), 48 Cal.2d 528 (1957)), the court reached out to find an obligation to reimburse [the cost of the successful defense](#). Nevertheless, forty years after *Lowell* insurers and insureds [continue to tangle](#) over the applicability of the duty to defend to cases of intentional torts.

Posted by Marc Mayerson at February 10, 2007 11:52 PM

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INSURANCE *SCRAWL*

by Marc Mayerson

Commentary on the Law of Insurance, the Insurance of Business, and the Business of Insurance

[« Now You See It, Now You Don't: Payments Received from Insolvent Insurers | Main | Caveat Advocat: Defense Lawyers as Coverage Lawyers »](#)

December 23, 2006

Caveat Advocat: Defense Lawyers as Coverage Lawyers

While insurance-coverage law has developed over the last 20 years into a rarefied specialty practice, lawyers who handle the defense of liability cases cannot punt on considering coverage issues – or they risk malpractice claims by their disgruntled clients. The New York Appellate Division recently confirmed that defense counsel may be exposed for failing to investigate the possibility of coverage – even where defense counsel has been retained by another insurance company for the benefit of the insured defendant.

In *Pacific v. Wilson, Elser, Moskowitz, Edelman & Dicker, LLP* (N.Y. App.Div. Dec. 19, 2006), the plaintiff – who was the defendant in a liability case – sued defense counsel for malpractice – not for dissatisfaction in how the defense case was handled but rather for failing to help in securing coverage in the event the defense mounted was unsuccessful. As the New York court framed the question:

The principal issue presented on this appeal concerns whether a law firm, retained by a primary carrier to defend its insured in a pending action, has any obligation to investigate whether the insured has excess coverage available and, if so, to file a timely notice of excess claim on the insured's behalf.

In *Pacific*, the insured was covered under a policy from certain underwriters at Lloyd's for \$1 million. The underlying plaintiff sought damages in excess of \$50 million, so in addition to appointing defense counsel to defend the insured against the suit, Lloyd's advised that the insured might wish to investigate whether additional excess coverage might be available.

The Wilson, Elser firm defended the suit against the insured, but lost a summary-judgment motion establishing the insured's liability. Two months later, before trial of the damages claim was set to commence, the firm, on behalf of the insured, tendered the defense to AIG, which denied coverage in part on the ground that it had not received prompt notice.

Several months later, the underlying plaintiff obtained a verdict against the insured for roughly \$6 million, well in excess of Lloyd's primary insurance policy limits. "In its [malpractice] complaint, the [insured] claimed that the [law firm] had been negligent in failing to advise [AIG] of the underlying action or, alternatively, that its failure to do so constituted a breach of contract."

The appellate court (ruling on a motion to dismiss) first examined whether the retention arrangement between the law firm and the insured made clear that the firm would not have any responsibility for investigating or pursuing coverage. The court in effect presumed that when a lawyer is retained to defend a case her responsibility includes investigating the possibility of insurance coverage. Cf. *Jordache Enterprises v. Brobeck, Phleger & Harrison* (Cal. July 30, 1998). As the court rules:

Thus, a legal malpractice plaintiff need not, in order to assert a viable cause of action, specifically plead that the alleged malpractice fell within the agreed scope of the defendant's representation. Rather, a legal malpractice defendant seeking dismissal . . . must tender document evidence conclusively establishing that the scope of its representation did not include matters relating to the alleged malpractice.

. . .

We turn, then, to the central question presented on this appeal: Whether a law firm retained by a carrier has any duty to ascertain whether the insured it was hired to represent has available excess coverage, or to file a timely notice of excess claim on the insured's behalf. The issue is best addressed by examining two questions. The first is whether, under ordinary circumstances, an attorney retained directly by a defendant in a personal injury action has any obligation to investigate the availability of insurance for his or her client and to see that timely notices of claim are served; the second is whether, if such an obligation exists, it also binds an attorney who is retained to defend a personal injury action, not by the defendant directly, but by the defendant's carrier.

The law firm argued that because it was appointed by an insurance company to represent the insured in the liability litigation it was plain that the scope of its representation was confined by the scope of the carrier's duty to defend (which is not ordinarily thought to include insurance-recovery issues) and that there was an implicit conflict of interest when defense counsel in a tripartite relationship is asked to opine on coverage issues. The New York Appellate Decision rejected these arguments, finding that there was no legal rule that prevented a lawyer from being sued for breach of professional duty when he fails to pursue coverage in connection with a matter he is defending.

One judge dissented strongly, writing:

The insured's contractual responsibility to notify its alleged excess insurance carrier cannot be avoided or diminished through the subterfuge of attempting to foist such obligation on an unsuspecting law firm selected by the primary carrier particularly where, as here, the law firm may have been assigned the case after the time to notify the excess carrier had expired.

Note that Wilson, Elser has not been found to have breached any duty to its former client. The issue on appeal is only whether a duty to investigate insurance coverage did not exist as

a matter of law. As a matter of fact, the firm can seek to show that the scope of its representation was confined or that it was reasonable in not pursuing the excess coverage here or that the plaintiff cannot establish causation or damages.

The lessons of the *Pacific* case for defense lawyers include (i) do not shirk investigating whether there is coverage for the case being defended or (ii) make clear in the retention letter that defense counsel's representation is limited to the defense of the case and expressly does not include advising on or investigating insurance coverage.

I think that the ordinary policyholder will not react negatively to a retention letter that states that the scope of counsel's representation is limited by the paying insurer's duty to defend and does not include advising the insured on the availability of coverage as against the defending insurer or against any other insurance company. But in the absence of an agreement making clear that defense counsel will not be advising about insurance, the lawyer may be exposed to a potential claim of breach of professional duty from the failure to pursue offsetting insurance for the client-defendant-insured. (And the law firm should look to its own E&O or professional-liability insurance for protection in the event a former client makes such a claim.)

Posted by Marc Mayerson at December 23, 2006 6:03 PM

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INSURANCE *SCRAWL* by Marc Mayerson

Commentary on the Law of Insurance, the Insurance of Business, and the Business of Insurance

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February 4, 2006

Fettering the Insurer's Privilege to Control the Defense It Is Duty Bound to Provide

For more than fifty years, policyholders and their insurers have been struggling over the insurer's promise to defend and the insurer's control the defense. Policyholders properly have been concerned that an insurance company that controls the defense of an action potentially covered by the carrier's duty to indemnify will use that control to avoid that very same indemnity obligation. While in egregious cases where a lawyer hired by the carrier has abused his or her relationship with the insured, the client, so as to favor the lawyer's source of income – the insurance company – the courts have responded to protect the insured's interests. But most courts have ruled that such after-the-fact remedies are insufficient: they do not adequately compensate for the injury; meritorious claims are not pursued (in part because insureds may not discover the abuse); and the potential for this abuse alone undermines the dominant purpose of the insurance relationship to afford protection and peace of mind for the insured.

As a result, most jurisdictions have fashioned a number of rules affording remedies in cases of actual abuse – by allowing bad-faith actions to proceed against insurers, by barring insurers from using the fruits of the poisonous tree, by allowing malpractice claims against the lawyer, and other measures. But most furthermore have held that where there is a situation of potential abuse a prophylactic approach is appropriate; thus the insured is permitted to select the lawyer to defend it and the carrier continues to have the obligation to pay for that defense. This is usually referred to as the "independent counsel" rule (or in California, the *Cumis* or 2860 rule).

Rarely do I see as a policyholder lawyer a insurance provision that expressly addresses this problem – something that is incomprehensible given that for more than two generations this struggle has been waged. Since at least the 1950s, the courts have made clear to insurers that, because their policies do not set out how these circumstances should be handled, the courts themselves will fashion rules designed to balance the interests of policyholders and their insurers. In general, the courts have looked to the dominant promise of the insurance contract to defend (and to indemnify) the insured and held that the correlative responsibility of the insurer to defend can yield to safeguarding that dominant purpose of the insurance contract. In part this stems from the contract drafting in which two words – "right and" -- in the insurance policy are what carriers rely on: they have the "right and duty to defend" (plus the insured's duty to cooperate set out in the boilerplate portion of the policy).

Because insurers are well aware of the rule that uncertainties in the contract will be construed against them and the rule in the overwhelming majority of jurisdictions that their right to defend and its entailed privilege of selection and control of counsel has to yield to protect the benefit of the bargain the insured struck to obtain both defense and indemnity, the courts generally have held that insurers forfeit their privilege of control.

The paradigmatic circumstance where the insurer's privilege of control yields to its duty to defend, to protecting the insured's expectations of coverage, and to subordination to the insured's interest is where a complaint alleges more than one claim arising out of a single event and the case can be lost on either a covered basis or an uncovered one. Take as an example where an during a pickup basketball game an elbow is thrown: if that occurred because of gross negligence, there will be coverage, but if it occurred because the player sought to intentionally injure the recipient, there won't be. Trial of the case involves the same facts and testimony either way, and ultimately it's up to the jury to weigh the testimony and the facts. The insurer if it is to lose the case would prefer to lose it on intentional-injury grounds, for then it won't have to pay the judgment.

Another example: assume there is a technical defense available to the covered claim; should the lawyer file a motion for summary judgment on the covered claim, which will effectively pretermit the carrier's ongoing obligation to defend (since the case no longer can eventuate in a judgment covered by the duty to indemnify)? Does the lawyer have an obligation to leave the weak claim hanging around just to preserve the defense or does the lawyer – whose bills are being paid by the insurer – have the obligation to clean out the dross and thus allow the carrier off the hook?

Insurers have pooh-poohed such concerns by contending that lawyers act ethically so the courts' concerns are unfounded. And the United States Court of Appeals for the Fourth Circuit – a court that has a [penchant for mispredicting state insurance law by siding with insurance companies](#) – recently agreed with the insurers in what should become carrier-side lawyers' favorite case to cite on these issues. In a well-written, well-analyzed, but erroneous ruling, [Twin City Fire Ins. Co. v. Ben Arnold-Sunbelt Beverage Co.](#) (4th Cir. Dec. 27, 2005), the Fourth Circuit rejected the argument that an insurer's reservation of the right to deny coverage called for prophylactic protection of the interest of the insured by allowing it to select counsel of its choice to defend at the insurer's expense.

Of course, *Ben Arnold* involves reasonably favorable set of facts for carriers and overbroad argument by the policyholder, but the court's ruling is not so confined. The court sets up the question presented as follows:

When a party with insurance coverage is sued, the insured notifies the insurance company of the suit. The insurance company, in turn, typically chooses, retains, and pays private counsel to represent the insured as to all claims. If the suit involves some claims that are covered under the insurance policy and some claims that are not covered, the insurance company typically will send a reservation of rights letter to the insured stating what claims the insurance company believes are covered and what claims it believes are not covered. In this case, we examine whether, under South Carolina law, such a reservation of

rights letter automatically triggers a conflict of interest entitling the insured to reject counsel tendered by the insurance company and instead to choose and retain its own counsel and to have the insurance company pay for that counsel.

Slip op. at 1. The proposition offered by the insured was that any time an insurer issues a reservation-of-rights letter it is still required to provide a defense but the policyholder gets to select counsel to defend it and control the course of the defense.

The Fourth Circuit rejected the policyholder's argument, noting correctly that courts tend to require that the insured show there to be a conflict of interest between it and the insurance company before wresting the defense from the carrier. This is sensible, of course, given that in the insurance policy the policyholder delegated to the insurance company the right to defend the case. Insurance companies issue reservation-of-rights letters in response to case law in the 1950s and 1960s that a carrier that defends a suit cannot turn around at the end of the case and tell the insured that it won't pay for the judgment – at least without alerting the insured of this possibility earlier; as a result, insurance companies issue reservations of rights to prevent the insured from having detrimental reliance (or claiming waiver). *National Mut. Ins. Co. v. McMahon & Sons*, 356 S.E. 2d 488, 493 (W. Va. 1987); *Safeco Ins. Co. v. Ellingshouse*, 725 P.2d 217, 221 (Mont. 1986); *Richmond v. Georgia Farm Bureau Mut. Ins. Co.*, 231 S.E.2d 245 (Ga. 1976); *Royal Ins. Co. v. Process Design Associates*, 582 N.E.2d 1234, 1239 (1st Dist. 1991).

But it is not the insurance company's fault that a suit may involve both covered and uncovered amounts, and coverage is not to be expanded beyond the terms of the policy through application of principles of waiver. As a result, it is entirely appropriate for an insurance company that is contractually obligated to provide a defense to a policyholder to alert it to the possibility that the judgment in the case might not be covered. *D.E.M. v. Allickson (North Star Mut. Ins. Co.)*, 555 N.W.2d 596 (N.D. 1996). In this way, the policyholder can act to protect its own interest, including in some states choosing to settle the lawsuit against it in a fashion that camouflages [whether the payment is also on account of uncovered amounts or claims](#). See generally *Miller v. Shugart*, 316 N.W.2d 729 (Minn. 1982).

So, unless some other interest or question is involved, the mere fact that an insurer sends a reservation-of-rights letter should not alter the parties' preexisting rights and powers (since all the insurer is trying to do is to avoid waiver/estoppel from its assuming the defense).

Against this background, the Fourth Circuit rejected the notion that a reservation-of-rights letter *per se* creates some sort of conflict between the interests of the insured and its insurer such that the insurer is divested of its contractually bargained-for right to defend. But the court went on to recognize that there are circumstances where the interest of the insured and the insurer in the development of the defense can diverge, which has led most courts to express concern about insurer-appointed and insurer-directed counsel.

The *Ben Arnold* court reviews the law in a number of jurisdictions (having found that South Carolina law applies and was without governing precedent) and concludes that some courts allow the insured to select counsel paid contemporaneously by the insurer whereas other

courts permit the insurer to select "independent" counsel who in turn may have heightened professional duties to safeguard the insured's interest. Because a strong undercurrent in those cases vesting the choice of counsel in the hands of the insured questions the ethical integrity of the insurance-defense bar, *e.g.*, *Howard v. Russell Stover Candies, Inc.*, 649 F.2d 620, 625 (8th Cir. 1981) (requiring independent counsel for fear that counsel for insurer "would be inclined, albeit acting in good faith, to bend his efforts, however unconsciously" in insurer's favor), the Fourth Circuit was highly reluctant to impugn with such a broad brush the integrity of an entire swath of the bar. Slip op. at 11 ("We are equally unable to conclude that the Supreme Court of South Carolina would profess so little confidence in the integrity of the members of the South Carolina Bar. Rigorous ethical standards govern South Carolina attorneys.").

The Fourth Circuit concluded that the ethical rules and discipline, "coupled with the threat of bad faith actions or malpractice actions if a lawyer violates these rules, provide strong external incentives for attorneys to comply with their ethical obligations." Slip op. at 12. Accordingly, the *Ben Arnold* court refused to find that, where there was a conflict of interest between the insured and the insurer in the development of the facts at issue in the liability case, the insured had a right to counsel of its choice, paid for contemporaneously by the insurer.

The court furthermore adopted a strict forfeiture rule in this regard, finding that if an insured rejected counsel tendered by an insurance company it forfeits the right to defense coverage. In other words, the policyholder is precluded from seeking coverage even if the insurance company cannot show that it was in any way was harmed by the policyholder's selection of counsel (*e.g.*, competent counsel at the same rate, for example, who obtains an outstanding result). The court rejected the policyholder's contention that the insurers must show substantial injury or prejudice or at least some detriment in order to be excused from providing the policyholder any of the benefit of the bargain. Slip op. at 13-15.

Ben Arnold is sure to be relied on by insurance companies as a cogent statement of their position in favor of rejecting the policyholder's selection of counsel of its choice. Nevertheless, the court need not have reached out to proclaim its own, pro-insurer prophylactic rule because the facts of the case and the conduct of the insurers at issue merit no such prolegomenon.

In *Ben Arnold*, the insurers retained qualified counsel to defend the covered counts and *in addition offered to pay for separate counsel to represent the insured's interests with respect to uncovered counts*. Moreover, with respect to a *different* insured in the case where there was a conflict of interest in the development of the facts, both the trial court and the Fourth Circuit found that independent counsel was required to be appointed at the carriers' expense. And even with respect to the principal insured for which there was no conflict at issue in the development of the underlying facts, the trial court recognized that at the time of settlement independent counsel might be required due to the conflict that then would be manifest. 2004 WL 2165971 (D.S.C. July 26, 2004), at n. 14.

What is lamentable about the Fourth Circuit's opinion is that the court could easily and more properly have held that, given the absence of a conflict of interest between the insured and

insurer in the development of the underlying facts, independent counsel was not required and in any event the insurers satisfied their obligations by offering to pay for two sets of counsel. This is the rule in "independent counsel" states where most courts recognize that merely sending a reservation-of-rights letter – without more – is insufficient to oust the insurer of the control of the defense. *National Union Fire Ins. Co. v. Hilton Hotels Corp.*, 1991 WL 405182 (N.D. Cal. 1991). In fact, wresting control whenever a reservation of rights is sent ironically defeats the purpose for why such reservations were sent in the first place.

But *Ben Arnold* should not be rejected just because it is overly broad, for even were the facts to match the very broad rule adopted that rule still would be ill advised and erroneous under principles both of insurance law and of contract law. Perhaps because the issue has been in dispute for so long (half-a-century), the footings of the independent-counsel rule seem to have become beclouded.

Let's look first at the consequences of the *Ben Arnold* court position. The court makes clear that, while there might a perception of discomfort by the policyholder in the carrier's selected lawyer being in charge (and thus having the ability to steer the defense toward uncovered grounds), the insured's interest is adequately protected because of legal-ethics rules, attorney-malpractice liability, and insurance bad-faith principles. This rejoinder to the policyholder position really does not withstand scrutiny.

The Fourth Circuit's remedies render nugatory the peace of mind and security the insured is supposed to receive by paying a premium to the insurance company for the broad protection afforded by insurance policies. See *Rawlings v. Apodaca*, 151 Ariz. 149, 154-55 (1986) ("Although the insured is not without remedies if he disagrees with the insurer, the very invocation of those remedies detracts significantly from the protection or security which was the objection of the transaction."). The court envisions requiring policyholders to endure bad faith or ethical breaches, and then seeking recovery only at the end of the underlying litigation by suing for legal malpractice or bad faith. *Ben Arnold* thus replaces the security that insurance is supposed to provide with a *chose in action* against the insurer-appointed lawyer, requiring the policyholder to (a) sue for legal malpractice, requiring a showing both of breach of the standard of care and a showing that the outcome would have been different (the "trial within the trial" of such malpractice actions), (b) undertake that action at its own expense (since the insurer is not paying, and there's no attorneys' fees recovery in malpractice cases), (c) in the meantime front the money for the adverse judgment in excess of policy limits or even the entire judgment if it is based on an uncovered claim (and subsequently, if successful, refund to the carrier in subrogation any amounts recovered after the policyholder was made whole), and (d) expose itself to an uncollectible judgment because the lawyer may not have assets sufficient to cover the judgment that resulted from his malpractice.

The *Ben Arnold* solution to the conundrum of insurer-appointed counsel further would do substantial injury to the attorney-client relationship; not only would the insured find it difficult to confide in counsel assigned to it, but counsel's effectiveness would be undermined by its knowledge that [the carrier has set it up for an impending malpractice action](#). And the same problems apply regarding suing the carrier for bad faith for some misconduct of the insurer-appointed lawyer or suing for negligent performance of the duty to defend by

providing inadequate counsel.

The proposed remedy that the *Ben Arnold* court contemplates is a feeble substitution for the security and protection that the policyholder thought it was paying for. And if one looks at the cases decided forty or fifty years ago, these courts found it salient that the insurers' policies did not spell out how this conflict situation would be handled. Standard insurance policies then (as now) were not written to state plainly and unambiguously that (i) interference with the right to defend forfeits coverage or (ii) the right to defend constitutes a material part of the consideration of the overall insurance transaction (which would be an overreach anyway given the aleatory nature of insurance contracts, that is, that the policyholder has fully performed its principal obligation of paying the premium).

Thus, the courts have applied the ordinary rules that where the policy language was uncertain and the insurer was in a position to clarify by drafting a provision clearly, the policy is construed in favor of coverage to achieve its purpose of indemnifying the insured, especially bearing in mind the reasonable expectations of insureds and avoiding the appearance of unseemliness from insurer-appointed counsel's being in the position to steer the case to favor his or her source of future business. *E.g.*, *Employers' Fire Ins. Co. v. Beals*, 240 A.2d 397, 402 (R.I. 1968); *Magoun v. Liberty Mut. Ins. Co.*, 195 N.E.2d 514 (Mass. 1964); *Prashker v. United States Guarantee Co.*, 136 N.E.2d 871 (N.Y. 1956); *see also CHI of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113, 1116 (Alaska 1993). As a result, most courts ruled that the carriers' right to control the defense – an ancillary part of the insurance contract – must yield to the predominate purpose of the contract to provide the policyholder a defense and to safeguard the policyholder's peace of mind. *See Jacobs & Youngs, Inc.*, 129 N.E. 889, 891 (N.Y. 1921) (Cardozo, J.) ("There will be no assumption of a purpose to visit venial faults with oppressive retribution."). That carriers have not fixed their policy language after 50 years of litigation and instead require that the law be developed in each state and locality smacks of ineptitude or bad faith or some synergistic combination of the two.

Nevertheless, one dissembling rejoinder to this would be to contemplate a situation where the policyholder does erroneously reject the carrier's offered defense (which approximates the actual facts in *Ben Arnold*). In that circumstance, so the argument goes, if the carrier remains responsible for funding the defense, the carrier that offers to perform properly is no better off than is the carrier that breaches its contract by refusing to provide a defense at all. In other words, a carrier that breaches its duty to defend by erroneously denying coverage is liable to pay the reasonable costs of defense; and according to this argument a carrier that offers counsel that is rejected by the policyholder is still obligated to pay the reasonable costs of defense.

This is a false counter, because *it misstates the damages that are to be paid by a breaching carrier* (that is, the contract-law damages it owes for breach of the duty to defend). It is not precise to say that a breaching insurer owes the reasonable costs of defense; rather, under *Hadley v. Baxendale*, the insurer owes all foreseeable damages. In the circumstances, the policyholder proffers in its *prima facie* case all defense costs it incurred (that were caused in fact by the carrier's failure to perform), and the carrier may argue by way of affirmative defense (and for which it has the burden of proof) that the costs were so unreasonable as to

constitute unforeseeable damages ([which when framed correctly](#) is a difficult standard for the carrier to meet, especially in the light of the fact that the insured had every economic incentive to incur only reasonable costs since, at the time, it was paying them out of its own pocket with no certainty of recovery from the carrier). Moreover, a breaching carrier is not just liable for defense costs, it is liable for all damages incurred by the insured from the breach. *Beck v. Farmers Insurance Exchange*, 701 P.2d 795, 801 (Utah 1985).

Contrast this situation to that of the carrier that does offer a defense but which is rejected by the policyholder on the ground that independent counsel is required – though in this illustration the policyholder is wrong to do that. In that circumstance, the concepts of material versus immaterial breach are key (as are dependent versus independent covenants). Here, the carrier has not breached, but the policyholder has. But the policyholder's breach – by interfering with the carrier's right of control – exposes the policyholder to the carrier's set-off claim because it is an immaterial breach of the overall contract. In other words, the carrier is still required to perform its contract – for the policyholder's breach is not a material breach of the contract excusing the carrier's obligation (especially when the policyholder has probably already paid the full premium). *See generally Steakhouse, Inc. v. Barnett*, 65 So.2d 736, 738 (Fla.1953)(defining dependent covenants). But because the policyholder did breach the contract, the carrier is entitled to show its damages from the policyholder's breach. In this context, what that means is the additional cost of the defense that would not have been incurred had the policyholder not breached (*i.e.*, not been in charged). So, if the defense counsel the insurer would have appointed charged only \$300 an hour (because of say a bulk deal with the carrier) and the policyholder's selected lawyer charges \$400 an hour, the carrier is not obligated to pay the \$100 an hour difference. (Unlike *Ben Arnold* where the carriers' to their mirth owe nothing.) Importantly, this is in contrast to the *breaching* carrier which is unlikely to be able to show that the \$100 an hour delta is such an unreasonable cost differential as to constitute unforeseeable damages under *Hadley v. Baxendale*. Moreover, the carrier that properly offered counsel is *not* exposed to paying the insured's *full* damages (sometimes pejoratively characterized as "consequential damages" ([Machan v. Unum Provident Ins. Co.](#), 2005 UT 37 (Utah June 17, 2005))), because it did not breach.

Thus, a carrier that properly tenders performance that is incorrectly rejected is not in the same (disadvantaged) position as is a carrier that breaches its contract. Accordingly, under this analysis, everyone is put in the position they would be in had the contract been properly performed – the benefit of the bargain is preserved.

Until such time, therefore, that insurers revise their contracts to specify that even in a conflict of interest situation the insurer still gets to appoint counsel (or whatever method it would propose, such as allowing the insured to pick from a list of five counsel suggested by the insurer), the uncertainty of the contract, and the disproportionality of the proposed remedy contemplated by the *Ben Arnold* court, confirms the rightness of the independent-counsel rule. *See generally* Restatement (2d) Contracts Sections 197, 229 (2004). If insurers do revise their contacts, then (i) insurance regulators would be in the position to weigh in, (ii) policyholders would know expressly what the process is for dealing with a conflict situation if it purchases the particular insurance policy, and (iii) policyholders could choose to purchase policies from other insurers that offer more generous terms. But it is folly to

believe that policyholders contemplate the remedial scheme adopted by the *Ben Arnold* court. See Restatement (2d) Contracts Section 211(3).

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Posted by Marc Mayerson at February 4, 2006 11:39 PM

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INSURANCE *SCRAWL* by Marc Mayerson

Commentary on the Law of Insurance, the Insurance of Business, and the Business of Insurance

[« Defending Defense Costs: Parrying the Attack of the Legal-Fee Auditors | Main | Tragedy and Failure »](#)

September 15, 2005

Defending Defense Costs: Parrying the Attack of the Legal-Fee Auditors

A common play by insurers that have failed to perform their duty to defend is to challenge the defense costs their policyholders incur on the grounds that they were unreasonable. The suggestion is that had the carrier defended the costs would have been less because the carrier would have hired cheaper defense counsel, or it would have ridden tighter herd on the costs incurred, or it would have required that only a limited number of lawyers be involved, or any of several other grounds for second-guessing the costs incurred by the policyholder. In addition to advancing these arguments, insurers have fabricated a specialized mouthpiece for making these points: "legal fee auditors." But both the legal premise and the "expert" testimony offered in support increasingly are being looked upon with the skepticism properly applied to the excuses of a breaching party that is seeking to reduce its obligation to pay damages - especially when that breaching party is an insurance company that was supposed to defend its insured in the first place.

The legal premise of a carrier's argument is that it needs to reimburse the insured only for "reasonable" defense costs, even if the policyholder already has spent the money. But this misconceives the legal context and the nature of the carrier's obligation. In these after-the-fact circumstances, the carrier's obligation is measured by ordinary principles of contract damages - and the hoary rule of *Hadley v. Baxendale*. *E.g.*, *Hajoca Corp. v. Security Trust Co.*, 25 A.2d 378, 381 (Del. 1942). The key to properly understanding the issues is to hold fast to first principles: when a party breaches a contract, the non-breaching party proves its recoverable damages by showing what was factually caused by the breach. In the context of the duty to defend, the natural and probable consequences of a breach of a duty to defend is that the policyholder will hire lawyers and experts to defend the suit against it. These costs, therefore, are the presumptive amount of damages for breach of the duty to defend.

Because the policyholder had no certainty that it would obtain recovery from someone else (i.e., the insurer), the amounts it incurred are presumed in the first instance to have been "reasonable" and "foreseeable." *E.g.*, *Aerojet-General Corp. v. Transport Indem. Co.*, 948 P.2d 990, 924-25 (Cal. 1997); *Lanier v. Lovett*, 213 P.2d 391, 394 (Ariz. 1923) ("The price agreed upon for labor or materials . . . is, prima facie, the reasonable value"); *Smith v. Champaign Urbana City Lines, Inc.*, 252 N.E.2d 381, 382 (Ill. App. 1969) (paid invoice prima facie evidence). Once the policyholder establishes the amounts it paid (which therefore would be sufficient to support a jury verdict in its favor on damages), the burden shifts to the carrier to prove by competent evidence that some or all of the insured's incurred costs

are so unreasonable as to constitute "unforeseeable" damages. See Marc Mayerson, *Insurance Recovery of Litigation Costs*, 30 Tort & Ins. L. J. 997 (1995). The presumption that costs incurred are reasonable or recoverable, though not conclusive, is a strong one: as the Seventh Circuit held:

When [the insured] hired its lawyers, and indeed at all times since, [the insurer] was vigorously denying that it had any duty to defend - any duty, therefore, to reimburse [the insured]. Because of the resulting uncertainty about reimbursement, [the insured] had an incentive to minimize its legal expenses (for it might not be able to shift them); and where there are market incentives to economize, there is no occasion for a painstaking judicial review.

Taco Bell Corp. v. Continental Cas. Co. (7th Cir. Nov. 5, 2004). Cf. *National American Ins. Co. v. Certain Underwriters at Lloyd's, London*, 93 F.3d 529, 539-40 (9th Cir. 1996); *Laffey v. Northwest Airlines Inc.*, 746 F.2d 4, 17 & n.88, 24-25 (D.C. Cir. 1984). (It is also worth mentioning that lawyers have an independent professional obligation only to charge a reasonable fee. DR 1.5; *Florida Bar v Herzog*, 521 So.2d 1118 (Fla. 1988).)

So, an insurer bears a heavy burden in showing that costs are so unreasonable as to constitute unrecoverable contract damages (recognizing the costs actually were already incurred). The means for the insurers to make these arguments in recent years has been via "legal fee auditors." These chaps - typically former lawyers for insurance companies and almost certainly not "auditors" - really are disguised advocates who lack professional training and opine with no professional standards guiding their work. The audit profession is a real one, of course, and audits require compliance with written standards, such as Generally Accepted Auditing Standards promulgated by the AICPA. See generally *Cumis Ins. Society Inc. v. Tooke*, 293 A.D. 2d 794, 797-98 (N.Y. App. Div. 2002). The "legal audit" firms are not part of such disinterested, professional organizations - instead, they are mouthpieces with a mission to flyspeck legal fees on an after-the-fact basis. Several courts have not welcomed the testimony offered by these auditors/advocates:

[The insurance company] submitted an affidavit by a firm that hires itself out to review lawyers' bills and that opined that [the insured] had overpaid the lawyers who represented it [in the underlying] litigation. We are unimpressed, as was the district court. . . The affidavit of the firm that picked through [the insured's] legal bills is excruciatingly detailed. The amount of time and money that went into its preparation and would be incurred in adjudicating its accuracy probably would exceed the potential excesses that it identifies.

Taco Bell, slip op. at 9. The District of Massachusetts recognized that the testimony of a legal auditor is not likely to pass muster under Fed. R. Evid. 702 and the *Daubert* rule. *E.g.*, *Liberty Mut. Ins. Co. v. Black & Decker Corp.*, 2004 WL 1941351 (D. Mass. Aug. 25, 2004), at *8 & n.8. In *Black & Decker*, the court indicated that a fee auditor from one of the national fee-auditing outfits lacked the "specialized knowledge" and methodology as to testify properly as an expert witness. *Id.* While the court sought to be generous in saying that the effort was still helpful to the court, helpfulness alone is not a sufficient basis for its admission

into evidence.

But there is an insurance spin that is worth returning to in evaluating the admissibility of the testimony of legal auditors and consideration of their project: As the Seventh Circuit concluded, "the duty to defend would be significantly undermined if an insurance company could, by the facile expedient of hiring an audit firm to pick apart law firm's billings, obtain an evidentiary hearing on how much of the insured's defense costs it had to reimburse." *Taco Bell*, slip op. at 10-11. To similar effect was the thinking of the District of Massachusetts:

Having declined to involve itself in the insured's conduct of the litigation once notified, [the insurer] is in no position ex post to complain that the insured's billing and litigation management policies do not meet its private criteria. The insurer that declines defense after notice cannot claim prejudice in the form of billing format or litigation practices that do not meet its standards, since it could have assumed the defense and imposed those standards.

Black & Decker, 2004 WL 1941351 at *8.

The context of breach of contract is different from the situations where an application for reimbursement of fees is submitted under a federal statute or in a bankruptcy proceeding. Just because the insured's damages for breach of contract are in the form of attorneys' fees does not mean that the standard of proof of damages is any different – a distinction insurers often seek to efface. Insurers thus often object to "block billing" or "inadequate descriptions" and argue that they are excused entirely from reimbursing such amounts, but this is simply wrong. The issue is whether a jury is provided with a non-speculative basis to determine the insured's damages – and in the circumstance of block billing or the like so long as one can be reasonably certain that the business methods of the law firm yields an accurate statement of the time spent on the matter, the insured has established its right to those damages. *E.g.*, *Jowdy v. Guerin*, 457 P.2d 745, 749 (Ct. App. 1969) ("Under Arizona law there is a distinction between the degree of proof necessary to establish the fact of damages and that necessary to fix the amount. Once the plaintiff has clearly established that he has suffered damages, his burden is relaxed and he need only show the amount with reasonable certainty, free from mere speculation or conjecture."). Lawyers bill for their time, not for their time descriptions (as the old "for services rendered" billing format confirms).

Similarly, some carriers have objected to including as an element of damages the costs of computerized legal research and other expenses, arguing that these are more properly overhead expenses; while such costs could be wrapped into the hourly rate at particular law firms, there is no impediment to billing for them separately. *E.g.*, ABA Comm. On Ethics and Prof'l Respo., Formal Op. 93-379 (Dec. 6, 1993). These are not per se unforeseeable costs and their being billed separately is not outside market practices.

None of this is to deny that clients should control the costs incurred by their counsel, and sophisticated corporate clients monitor the costs incurred and the manner of their billing – because they are paying for it! There are innumerable ways to structure the fees and expenses of lawyers, including increasing the lawyers' billing rates so that expenses are no

longer broken out (i.e., setting the rate so that the firm absorbs expenses rather than setting rates contemplating that expenses are separately billed); clients may impose standards for how law firms use outside vendors for copying and the like. Some clients want task-based billing and are willing to pay for it; others are satisfied with daily billing or what carriers like to call "block" billing. All of these may be appropriate business deals to work out with defense counsel. The point here, however, is in determining a carrier's obligation to reimburse defense costs all of these quibbles are too late – in a breach of contract the insured shows what it spent and the breaching party bears a heavy burden of showing that costs that were spent and were caused by its breach should nonetheless not be awarded as an element of damages. Holding fast to these straightforward principles of contract law and damages jurisprudence simplifies coverage cases and streamlines the presentation of damages evidence at trial (to the considerable relief of jurors).

In one of my cases, the legal auditor purported to question 73 percent of all the defense costs incurred for a sophisticated client by a leading employment-liability defense firm, preparing a report of some 748 pages. This should be Exhibit A in showing that this entire project quite properly is a dead-end, as the Seventh Circuit and District of Massachusetts both found.

Posted by Marc Mayerson at September 15, 2005 12:14 PM

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