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Horns of a Defense Counsel Dilemma

Insurance Conflicts Counsel Can Help Avoid Losing Your Coverage

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What happens when an attorney acts on behalf of two clients with potentially diverging interests — a policyholder in the midst of defending important litigation and the liability insurance company paying the defense bills? How can policyholders ensure that insurance company-appointed defense counsel are able to defend the policyholder without worry of conflicts with the insurance company? This article examines the conflicts that surround the so-called "tripartite relationship" among policyholder, insurance company, and defense counsel hired by the insurance company, as well as techniques to preserve defense counsel's un-conflicted duty to its client, the policyholder. Insurance conflicts counsel is one such technique.

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Three's a Crowd: The Duty to Defend the Tripartite Relationship

The tripartite relationship has its origins in the two-part duty of the insurance company as defined in the typical insurance policy. Liability insurance policies typically provide protection against: 1) the cost of defending a lawsuit; and 2) any damages arising out of or related to the claim, such as the cost of a settlement or an eventual jury verdict. As a general rule, an insurance company's duty to defend the policyholder is much broader than its duty to indemnify. Indeed, the duty to defend may be activated or "triggered" even if the insurance company ultimately has no obligation to indemnify the policyholder for a loss. If a complaint states several potential grounds of liability and any single one of those grounds is potentially covered by any provision of the insurance policy, the policyholder is entitled to a defense. The insurance company is not excused from providing a defense unless the complaint against the policyholder clearly shows that there is no possible basis for coverage.

While some insurance policies permit the policyholder to choose its own defense counsel, many policies consign this right to the insurance company. In such cases, the insurance company generally will hire defense counsel from a "panel" of firms with which the insurance company regularly deals. This means that the defense attorney will generally have an ongoing relationship with the insurance company, while the attorney's relationship with the policyholder will be limited to the defense of this single case. (*See* Douglas R. Richmond, *Walking a Tightrope: The Tripartite Relationship Between Insurer, Insured, and Insurance Defense Counsel*, 73 NEB. L. REV. 266, 1994.)

Problems Arising out of The Tripartite Relationship

So long as the insurance company's interests appear to be harmonious with those of the policyholder, the parties to the tripartite relationship may be somewhat sturdy. Far too often — more often in our experience with significant-sized claims —conflicts regarding coverage between the insurance company and policyholder emerge. What happens, for example, when the insurance company defends the under a reservation of rights — that is, an insurance company's assertion that it reserves the right to deny coverage, despite its initial agreement to defend? What if claimed damages exceed coverage? What if the insurance company nixes a strategic course of action that defense counsel believes will help the policyholder's case?

Conflicts of interest between the pol-

icyholder and the insurance company (thus potentially conflicting appointed defense counsel) can arise in various assertions by insurance companies of non-coverage, *e.g.*: 1) allegations in the claim do not fit the scope of coverage; 2) the allegations fit an exclusion in the policy; 3) the damages sought do not fit the damages covered in the policy; 4) the amount of damages sought exceeds the policy's limits; 5) the coverage has been eroded under an "aggregate" limit of liability; 6) the policyholder has "other" insurance; or 7) the policyholder has breached a condition, among others.

Courts across the country have stated that when a conflict arises between an insurance company and the policyholder, appointed defense counsel has a natural tendency to favor the interests of the insurance company. As the federal Eighth Circuit stated in *United States Fidelity & Guar. Co. v. Louis A. Roser Co.*, 585 F.2d 932, 938 n.5 (8th Cir. 1978), "the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client — the one who is paying his fee and from whom he hopes to receive future business — the insurance company."

Conflicts between an insurance company and its policyholder may put defense counsel in the unworkable position of mediating a conflict on insurance coverage issues with the insurance company while trying to properly defend the policyholder. Under such circumstances in-house counsel may find themselves in need of insurance "conflicts counsel" — counsel working on behalf of the policyholder to resolve insurance coverage issues and permitting defense counsel to focus upon defense issues without concern for potential conflicts with the insurance company.

When Your Insurance Company Seeks to Limit Coverage and Your Defense

An insurance company's reservation of rights presents a classic conflict of interest. Since the insurance company believes it may later prevail on a coverage issue, is it taking a diminished interest in your defense? What if some of the claims asserted against the policyholder are covered by the insurance policy and others are not? Might the insurance company attempt to influence defense counsel to provide a less vigorous defense to those claims that are *not* covered under the policyholder's policy?

In *Nandorf v. CNA Insurance Companies*, 479 N.E.2d. 988 (Ill. App. Ct. 1985), the policyholder contended that the defense provided by its insurance company pursuant to its reservation of rights created a conflict of interest that entitled the policyholder to retain independent counsel paid for by the insurance company. The court agreed, stating:

> [a]s a result of its reservation of rights, CNA [the insurance company] had an interest in providing a less than vigorous defense to allegations … which, if proven, would have supported an imposition of punitive damages … CNA's failure to vigorously defend those allegations would have had the effect of subjecting its insured to greater liability. Clearly, the insurer's fidelity to its insured was hampered by its own interests in this case (at 991-992).

An insurance company sometimes attempts to reserve the right to disclaim coverage based on a policy defense, such as the policyholder's failure to give timely notice. In *Continental Ins. Co. v. Bayless & Roberts*, 608 P.2d 281 (Alaska 1980), the court stated that an insurance company with a reserved policy defense may only offer a "token defense" if it knows that the loss that it is defending will not be covered. The court reasoned that "[i]f the insurer does not think that the loss on which it is defending will be covered under the policy, it may not be motivated to achieve the lowest possible settlement or in other ways treat the interests of its insured as its own."

Alternatively, the insurance company may assert that although no condition of the policy has been breached by the policyholder, a particular claim made by the plaintiff does not come within coverage. If the policyholder has been sued on alternative theories of recovery, at least one of which is not covered, the insurance company will have an interest in seeing the plaintiff obtain a verdict based on the theory under which no coverage would result. In practice, these conflicts can be vexing.

When the Insurance Company Chooses Its Bottom Line over Your Defense

Over the past 20 years, insurance companies have increasingly turned to the use of billing "guidelines" in an effort to explain to retained defense counsel the insurance company's expectations of the representation. An insurance company's billing guidelines might attempt to mandate that counsel obtain approval from the company before engaging in particular litigation activities, such as written discovery or taking certain depositions. Such guidelines often interfere with the independent exercise of retained counsel's professional judgment. In *In the Matter of the Rules of Professional Conduct and Insurer Imposed Billing Rules and Procedure*, 2 P.3d 806, 814 (Mont. 2000), the court held that an insurance company was not a client of retained counsel, and thus the requirement of prior approval in billing conflicted with counsel's duties to their client, the policyholder, under the Rules of Professional Conduct. The court further states that, "the requirement of prior approval fundamentally interferes with defense counsel's exercise of their *independent* judgment" (at 815, emphasis added).

Another situation ripe for potential conflict arises when claimed damages exceed policy limits. This conflict can arise where a good potential liability defense exists, but defense counsel knows that the case can be settled within policy limits. While the insurance company may seek to litigate the liability defense aggressively, it may be in the best interest of the policyholder —— facing damages in excess of limits — to settle for an amount within the policy limits.

Defense counsel who fail to settle a case within policy limits, despite the chance to do so, may be liable in malpractice for an excess judgment. In a Ninth Circuit case, *I Mutuelles Unies v. Kroll & Linstrom*, 957 F.2d 707 (2d. Cir. 1992), the plaintiff in the underlying action wanted $1 million to settle, but defense counsel (at the instruction of the insurance company) refused to offer more than $900,000.

The insurance company gained the difference between the plaintiff's lowest settlement offer and the ultimate jury verdict. Defense counsel was not so fortunate, and faced a malpractice verdict in excess of $2 million. Conflicts counsel might have avoided the problem for defense counsel.

When Defense Counsel Learn About Potential Coverage Defenses

Defense counsel may also find themselves in receipt of confidential or privileged information which could be used to limit or even vitiate coverage. What if, for example, defense counsel becomes privy to facts that indicate the policyholder committed an act intentionally, thus negating any coverage under the policy? The attorney's duty to preserve the confidentiality of information under Model Rule 1.6 of the American Bar Association's Model Rules of Professional Conduct requires the attorney to refuse to disclose certain information to the insurance company absent the policyholder's consent. If the policyholder is entitled to know such information, and the policyholder refuses to give counsel the consent to divulge the information, then defense counsel probably should advise the policyholder to retain separate conflicts counsel to protect the policyholder's rights in a potential coverage action with the insurance company. (*See* Will B. Berkeley, *Tripartite Ethics: Confidential Communications Among the Insured, the Insurer, and Defense Counsel*, THE BRIEF, Spring 1997, at 24.)

USING INDEPENDENT DEFENSE AND 'CONFLICTS COUNSEL'

Independent Defense Counsel: Your Attorney

When an insurance company asserts a reservation of rights, some courts have held that a conflict of interest arises between the insurance company and policyholder, entitling the policyholder to a defense by an attorney of his own choosing, whose reasonable fee is to be paid by the insurance company.

A landmark case establishing this right was *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc,* 208 Cal. Rptr. 494 (Cal. App. 1984), in which the plaintiff sued several parties insured by Cumis Insurance. Cumis selected counsel to represent the policyholders but also sent a reservation of rights letter denying coverage for damages caused by intentional conduct. The court held that if the policyholder who is offered representation under reservation of rights does not consent to dual representation by the insurance company's chosen counsel, the insurance company must pay the reasonable cost of independent counsel hired by the policyholder.

Similarly, in *CHI of Alaska, Inc. v. Employers Reinsurance Corp.*, 844 P.2d 1113 (Alaska 1993), the court applied a broad rule to protect the interests of policyholders from conflicted counsel:

> [T]he general rule is that, if an insured refuses to accede to the insurer's reservation of rights, the carrier must either accept liability under the policy and defend unconditionally or surrender control of the defense. (at 1118).

Today, the idea that the policyholder may be entitled to outside counsel is known as the independent counsel doctrine. Under this doctrine, many states require the appointment of independent counsel to represent the policyholder where certain conflicts of interest arise between the insurance company and the policyholder. Insurance companies often do not concede that the appointment of independent counsel is necessary. Policyholders may need to fight in order to obtain independent counsel.

Making Sure Your Best Interest Is The Insurance Company's Interest

Corporate counsel and defense counsel may also look to insurance conflicts counsel to avoid difficult conflict questions arising out of the tripartite relationship. The use of conflicts counsel was popularized in bankruptcy proceedings, where firms representing debtors in enormous "mega-bankruptcies" inevitably found that some of the creditors were also firm clients, and hired outside counsel, or "conflicts counsel," to assist in the handling of these claims. The same principle applies in cases involving insurance coverage: defense counsel who recognize that their clients have a disputed claim against their insurance company may elect to have conflicts counsel handle those sensitive aspects of a case. Conflicts counsel may work with defense counsel to convince the insurance company that a settlement or a litigation strategy is proper. Finally, conflicts counsel may take all steps necessary to ensure that the insurance company provides a full defense as mandated by the insurance policy, even bringing a coverage action if necessary.

Although the tripartite relationship is exclusive to insurance defense, the insurance company's appointed counsel is subject to the same ethical rules that govern all other lawyers. Most states have now adopted the ABA's Model Rules of Professional Conduct, several of which, are directly applicable to this relationship. Model Rule 1.8, for example, mandates that a lawyer shall not accept compensation for representing a client from someone other than the client unless the client consents, and unless there is no interference with the lawyer's independence of professional judgment or with the lawyer-client relationship. Compliance with this rule may require defense counsel to disagree with the insurance company, which may be attempting to control the litigation. Defense counsel may be required to ignore certain of the insurance company's instructions with respect to a strategic decision. Conflicts counsel can assist in separating the defense of the underlying claim from the potential coverage dispute with the insurance company.

CONCLUSION

Many policyholders do not realize that their defense counsel may be facing conflicts when coverage issues arise. The tripartite relationship becomes even more difficult should a conflict arise — for example, a dispute over the scope of insurance coverage or the assertion of a reservation of rights letter. Under these circumstances, in-house counsel should consider the use of independent defense counsel and conflicts counsel.


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