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The Lasso Way: We Want a Tie

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THE LASSO WAY: WE WANT A TIE

Working together to resolve complex litigation matters under a reservation of rights can make the insured and the insurance company feel more like adversaries than teammates. Covered versus non-covered claims, additional insured issues and first and third-party claims all influence the game plan. Add the risk of excess exposure to pitch and you have potential conflicts that don't even involve your opponent. The duty of good faith and the duty to cooperate are not just buzz words but real-life obligations. This panel will explore the challenges and successful approaches to achieving the best outcome (sometimes, that's a tie!) in these scenarios.

During our collaborative and open roundtable discussion, we will discuss real-world issues, obstacles and successes when working with challenging litigation and defenses provided under a reservation of rights. This contribution is intended to provide some basic and well-vetted guidance on issues that frequently arise when reservations of rights are in play.

Pre-Game: What is a Reservation of Rights?

The Tender. When an insurer first receives notice of a claim or suit against its insured, the insurer must, with reasonable promptness, take one of the following actions:

1. acknowledge receipt of the notice and advise that it will provide coverage;
2. advise the insured that it will defend the insured subject to a reservation of its right to deny coverage on one or more specified grounds;
3. deny coverage on the grounds that the claim is either not covered under the policy or that the insured has breached a policy condition; or
4. rescind the policy if it appears that the policy was procured through fraud, mutual mistake of fact, or the insured's misrepresentation of material facts in the application.

The Reservation of Rights is written notice to the insured that a claim might not be covered due to some exclusions or defenses. If after investigation of a claim the insurer perceives that coverage may be in question, the prudent course is to defend the insured subject to a reservation of rights [if there is a duty to defend]. However, if there is no duty to defend, it is still wise to send a reservation of rights letter to protect the insurers' interests. The insurers issuance of a reservation of rights letter allows it to suspend the operation of defenses based on waiver and estoppel. The insurer should set out in a reservation every reason of which the insurer is aware, for a denial or limitation of coverage.

Furthermore, the letter should contain a provision such as "The insurer hereby reserves its rights to assert other defenses as they become known." This will better enable the insurer to assert other grounds for denying coverage as they become known. The insurer must be sure, however, to issue an additional reservation letter once other grounds for denying coverage arise.

There are two defenses to an insurer's reservation of rights: waiver and estoppel. These will

effectively deny the insurer the opportunity to assert grounds for denying coverage in certain circumstances. A key element that arises in waiver and estoppel is prejudice. In most cases, prejudice must be shown. The insured must have justifiably relied on some action of the insurer to his/her detriment. However, in certain cases prejudice will be presumed. Prejudice is presumed when there is a material encroachment on some right of the insured.

1. A reservation of rights is a court-created concept that protects insurers by allowing them to exercise their right and duty to defend without waiving coverage defenses.

2. Defending under a reservation of rights is NOT a breach of contract or bad faith.

3. Defending under a reservation of rights is NOT an acknowledgment of a duty to defend; an insurer may prefer to incur the cost of defending even non-covered suits to avoid risk of default and maintain control over defense.

When Is A Reservation of Rights Needed? The answer varies. As a rule, as soon as possible given the varying dynamics, which include:

1. Most states have statutes or regulations governing when an insurer must respond to an insured's tender.

2. In general, an insurer should send a short letter as soon as possible after receiving notice acknowledging receipt and creating a line of communication while reserving rights pending the conclusion of an insurer's claims investigation.

3. A more substantive letter identifying specific coverage concerns should be sent within 30 days explaining why coverage may not apply. If more time is needed, send an interim letter explaining why.

4. A reservation of rights letter should be sent only by the insurance company or secondarily by independent counsel representing the insurance company. It should not be sent by independent counsel engaged by the insurer to defend the policyholder in a third-party claim.

The Match: It's Go Time.

The Right to Defend, in plain language, is the right to select counsel and control the defense of a suit against a policyholder. The right is found in a policy's insuring agreement with language similar to: "the company shall have the right and duty to defend any suit against an insured seeking [covered] damages."

No single feature of a liability insurance policy has a greater impact upon an insurer's ultimate payment obligations than the right and duty to defend. An insurer's decision as to whether it has a duty to defend or not can have significant ramifications throughout the course of a claim, as regards to the insurer's immediate payment obligations, the course of conduct that a policyholder is likely to adopt as regards the third-party tort claimant, and, in some jurisdictions, with respect to whether the insurer, if

found to have a duty to defend, now owes attorneys' fees, consequential damages, or may even be estopped to dispute whether it has an indemnity obligation.

It bears recalling that this defense undertaking is not only a *duty*, below, but a *right.* The *right* to defend is a valuable tool bargained for by insurers in the creation of such policies. In consideration of the insurer's promise to defend, the insured has relinquished control over the defense of the case. As a consequence, the insurer typically has dominion over decisions with respect to how the case should be defended and/or settled or tried. The right to defend gives an insurer control over the manner of defense and disposed of. This can have great significance as to the ultimate cost of defense and in ensuring that the case is resolved on its merits.

The Independent Counsel Doctrine. Even so, the right to defend is also a duty to defend and as such, is not without limitations and obligations of the carrier. Not only have most courts ruled that the defense must be conducted in accordance with the implied duty of good faith and fair dealing, but in many states an insurer may lose the right to defend if a conflict exists between insurer and insured, such that allowing the insurer to maintain control of the defense could prove harmful to the insured's interests.

Cases in which policyholders have claimed that a conflict of interest exists, warranting their right to select independent counsel, have tended to arise in two specific situations:

1. *Disputes Over Insurance Coverage:* Most of the "conflicts" jurisprudence concerns cases in which the insurer has agreed to provide a defense to its policyholder, albeit under a reservation of rights due to certain coverage concerns. In such cases, courts have sometimes found that the insurer may not be allowed to control the defense because its reserved rights have created a conflict with its insured.

2. *Disputes Over Litigation Management:* Even in cases where the insurer has accepted coverage, is there a right to independent counsel if the parties disagree with respect to litigation strategy and that disagreement could result in uninsured damages, either because there could be a verdict in excess of policy limits or because the insurer's case handling strategy could affect types of damage that are not insured under the policy (*e.g.* business reputation)? Similar issues have lately been raised concerning insurer efforts to impose litigation management guidelines.

Conflicts over Insurance Coverage. Several courts have found that an insured should not be forced to give up control of its own defense if the insurer, by raising coverage issues, has an incentive to handle the defense in a manner that supports the interest of the insurer but not the policyholder. *Chi of Alaska, Inc. v. Employers Reinsurance Corp.,* 844 P.2d 1113 (Alaska 1993); *Farmers Ins. Co. v. Vagnozzi*, 138 Ariz. 443, 675 P.2d 703 (1983); *Maryland Cas. Co. v. Peppers*, 355 N.E.2d 24, 31 (Ill. 1976); *Patrons Mutual Ins. Assoc. v. Harmon,* 732 P.2d 741 (Kan. 1987); *Allstate Ins. Co. v. Campbell*, 639 A.2d 652, 659 (Md. 1994); *Prahm v. Rupp Construction Co.,* 277 N.W.2d 389, 391 (Minn. 1979); *Moeller v. American Guaranty & Liability Ins. Co.,* 707 So.2d 1062 (Miss. 1996); *American Employers Ins. Co. v. Crawford,* 533 P.2d 1203, 1209 (N.M. 1975); *69th Street Garage Associates v. Ticor Title Guaranty Co.,* 622 N.Y.S.2d 13, 14 (App. Div.

1995); *State Farm Fire & Casualty Co. v. Pildiner,* 321 N.E.2d 600, 603 (Ohio 1974) and *Lima v. Chambers,* 657 P.2d 279, 285 (Utah 1982).

Conflicts Over Litigation Strategy and Goals. As above, most of the cases in this area have focused on coverage-based conflicts arising out of reservation of rights letters wherein the insurer agrees to provide a full defense but states that its indemnity obligations may not apply to some of the claims presented against the policyholder. In recent years, however, insureds have sought to expand the scope of their right to independent counsel to also encompass other claimed sources of conflict. In particular, some insureds have argued that they should have a right to independent counsel, even in cases where the insurer has accepted coverage, if the parties disagree with respect to how the defense is conducted and that disagreement could result in uninsured damages, either because there could be a verdict in excess of policy limits or because the insurer's case handling strategy could affect types of damage that are not insured under the policy (*e.g.* business reputation).

To date, courts have not recognized disagreements concerning litigation strategy as a valid basis for annulling the insurer's right to defend. For example, the Texas Supreme Court ruled in *Northern County Ins. Co. v. Davalos, 140 S.W.3d 685* (Tex. 2004), that "every disagreement about how the defense should be conducted cannot amount to a conflict of interest…If it did, the insured, not the insurer, could control the defense by merely disagreeing with the insurer's actions." While outlining various types of coverage disputes or extracontractual demands that might give rise to such a conflict, the Supreme Court declared in this instance that the insured's unwarranted rejection of the defense offered by his insurer precluded any right to reimbursement of his own defense costs. The court left open the possibility that independent counsel could be required in cases where:

1. The defense tendered "is not a complete defense under circumstances in which it should have been."

2. The "attorney hired by the carrier acts unethically and, at the insurer's direction, advances the insurer's interest at the expense of the insured's."

3. The insurer intends to obtain some type of concession from the insured before its agreement to defend will defend.

Nor have courts found that the insured's belief that the law firm assigned to defend it is inadequate to the task is a valid basis for requiring the insurer to pay for "shadow" counsel or for counsel of the insured's own choosing. In *Driggs Corp. v. Pennsylvania Manufacturers Association Ins. Co.,* 181 F.3d 87 (4th Cir. 1999)(Unpublished—full text available at 1999 U.S. App. LEXIS 9182), the U.S. Court of Appeals for the Fourth Circuit ruled in a Maryland environmental liability case that insurers had not created a conflict entitling the insured to independent counsel where they had provided a defense while reserving rights as to the applicable trigger of coverage and whether the absolute pollution exclusion applied. The court noted that, whatever trigger was found to apply, one insurer or the other would pay and that, as to the exclusion, the insured had conceded that it precluded any indemnity obligation. As a result, the Fourth Circuit held that the carriers had no obligation to reimburse the insured for attorney's fees that Kirkpatrick & Lockhart had incurred in supplementing the work of the small insurance defense

firm that the carriers had retained to defend Driggs.

Implications of Conflicts For Insurer's Right To Control Defense. Assuming that a conflict of interest is found to exist, what are its implications for the insurer's right to control the defense of its insured? Depending on the jurisdiction in which the conflict arises, the insurer may lose some or all of the rights ordinarily inherent in the right to defend.[1] In particular, courts have to date adopted five different approaches to this problem:

1. *Reject the Defense:* The most extreme of these approaches holds that an insured has the right to reject the insurer's tender of a defense in any case where the insurer is reserving rights, without regard to the nature of the coverage issue.

2. *Cumis:* A more common approach, named after the California case that pioneered it, is to only deprive the insurer of the right to defend if the issue on which the insurer is reserving rights is such that the manner in which the defense is conducted will affect the availability of insurance coverage for any resulting judgment.

3. *Shared Rights:* A few states, notably Florida, find that where a conflict of interest exist, the insurer and insured must jointly agree on the selection of defense counsel.

4. *Enhanced Duty of Good Faith:* Hawaii and Washington have ruled that an insurer retains the unilateral right to appoint counsel and control the insured's defense despite a conflict but is subject to an enhanced duty of good faith in its exercise of this right and subject to extracontractual penalties if it fails to live up to this standard.

5. *Rely On Ethics of Defense Counsel:* Finally, a few states have ruled that insurers need not pay for independent defense counsel because the ethical obligations that all lawyers must abide by are sufficient to safeguard the insured against the consequences of any claimed coverage conflict.

The Best Defense is a Good Offense: "Reject the Defense" Cases

At one extreme are those cases that have concluded that all reservations of rights create a conflict of interest warranting the retention of independent counsel without regard to whether the coverage dispute is of such a nature that it could influence the manner in which the case is defended. *See, e.g. See, Boise Motor Car Co. v. St. Paul Mercury Indem. Co.,* 112 P.2d 1011, 1016 (Idaho 1941); *Medical Protective Co. v. Davis,* 581 S.W.2d 25, 26 (Ky. Ct. App. 1979); *State Farm Mut. Auto. Ins. Co. v. Ballmer,* 899 S.W.2d523, 527 (Mo. 1995); *Merchants*

[1] For a more detailed analysis of these issues and the case law that has emerged in specific jurisdictions, the reader is referred to the numerous law review articles that have been published on these issues, including: Douglas R. Richmond, *Liability Insurers' Right to Defend their Insureds*, 35 Creighton L Rev. 115 (2001); Robert H. Jerry, II, *The Insurer's Right to Reimbursement of Defense Costs*, 42 ARIZ. L. REV. 13 (2000); Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1 (1999); William T. Barker, *Insurance Defense Ethics and the Liability Insurance Bargain*, 4 CONN INS. L.J. 75 (1997-98).

Indem. Corp. v. Eggleston, 179 A.2d 505, 511-12 (1962); *National Mortgage Corp. v. American Title Ins. Co.,* 255 S.E.2d 622, 629-30 (N.C. Ct. App. 1979), *rev'd on other grounds,* 261 S.E.2d 844 (N.C. 1980).

As the Supreme Judicial Court of Massachusetts explained in *Three Sons, Inc. v. Phoenix Ins. Co.,* 357 Mass. 271, 274, 257 N.E.2d 774, 776-77 (Mass. 1970), "when an insurer seeks to defend its insured under a reservation of rights, and the insured is unwilling that the insurer do so, the insured may require the insurer either to relinquish its reservation or rights or relinquish its defense of the insured and reimburse the insured for its defense costs." The Court went on to state that:

> Control of the case by the insurer, when it may later disclaim liability under the policy, means that the insured's rights may be adversely affected. He has no opportunity to control aspects of the case essential to determination of liability or settlement. If liability is established, or a settlement reached, and the insurer has a valid ground for disclaimer, the insured is left with a liability which, had he been able to defend or settle on other terms, might never have existed.

This remains a minority view. Explaining why, the U.S. Court of Appeals for the Fourth Circuit rejected a South Carolina insured's contention that every reservation of rights letter gave rise to a right to independent counsel. In predicting that the South Carolina Supreme Court would reject a "per se disqualification" rule, the court opined in *Twin City Fire Ins. Co. v. Ben-Arnold Sunbelt Beverage Co.,* 433 F.3d 365 (4th Cir. 2005) that Twin City's reservation of rights with respect to whether Coverage B in a CGL policy extended to a sexual harassment suit did not create a conflict of interest, nor did it give its insured the right to unilaterally reject the law firm proposed by the insurers or to retain counsel of its own choosing and settle the claims without the insurers' participation. The Fourth Circuit expressed confidence in the ethical integrity of South Carolina insurance defense counsel to defend such claims without compromising the insured's interests. The court noted that the insured was still free to reject the lawyers hired by its insurer but thereafter must pay for its own defense. The court also rejected the insured's argument that the insurers were equitably estopped by reason of their appointment of "unqualified" defense counsel, noting that the lawyer in question was, in fact, a skilled and experienced defense attorney.

"Total" Litigation: The Cumis Cases

As with *Sunbelt,* most courts have taken a more nuanced issue to reservation of rights letters and have declared that they will only give rise to a conflict of interest if the issue(s) on which the insurer has reserved rights is such that defense counsel could shape the conduct of the defense to the detriment of the policyholder and the benefit of the insurer. In short, does trial counsel have the ability to defend the case in such a way that it is more likely that a judgment could result for which only the insured would be liable?

The leading case enunciating this approach is *San Diego Federal Credit Union v. Cumis Ins. Society,* 162 Cal. App.2d 358 (1984). In *Cumis,* the insured was sued for $750,000 in general damages, and $6.5 million in punitive damages for tortious wrongful discharge, breach of the covenant of good faith and fair dealing, wrongful interference with and inducing breach of contract, breach of contract and intentional infliction of emotional distress. The insurer agreed to provide the insured a defense against the entire action and retained defense counsel, but reserved its right to deny coverage for any punitive damages liability. *Id.* at 362. The insured retained its own counsel and demanded that the insurer pay for it. Although the insurer in fact paid two invoices, it later denied any further responsibility to pay for the insureds' independent counsel. The insured then brought an action against the insurer.

The California Court of Appeal recognized that when the insurer is providing a defense under a reservation of rights, the usual shared goal of minimizing or eliminating liability to the third-party claimant may not exist. In such cases:

> The Canons of Ethics impose upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage. If the insured does not give an informed consent to continued representation, counsel must cease to represent both. Moreover, in the absence of such consent, where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible non-coverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation. Disregarding the common interests of both insured and insurer in finding total non-liability in the third-party action, the remaining interests of the two diverge to such an extent as to create an actual, ethical conflict of interest warranting payment for the insured's independent counsel.

The *Cumis* rule has since been codified as California Civil Code Section 2860, which provides that that a conflict of interest "may" exist, so to require an insurer to provide the insured "independent counsel" at the insurer's expense, if the "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." Stated another way, "[i]t is only when the basis for the reservation of rights is such as to cause assertion of factual or legal theories which undermine or are contrary to the positions to be asserted in the liability case that a conflict of interest sufficient to require independent counsel, to be chosen by the insured, will arise." *State Farm Fire & Casualty Co. v. Superior Court*, 216 Cal. App.3d 1222, 1226, n. 3 (1989).

Codified in modified form as California Civil Code Section 2860 (1996), the *Cumis* approach gives insureds the right to select qualified counsel of their own choosing but only in the event of a genuine conflict. Thus, Section 2860(b) provides that:

> For purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage; however, 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, a conflict of interest may exist. No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

Both statutory and case law make clear that not every conflict of interest triggers an obligation on the part of the insurer to provide the insured with independent counsel at the insurer's expense. For example, the mere fact the insurer disputes coverage does not entitle the insured to *Cumis* counsel; nor does the fact the complaint seeks punitive damages or damages in excess of policy limits. The insurer owes no duty to provide independent counsel in these situations because the *Cumis* rule is not based on insurance law but on the ethical duty of an attorney to avoid representing conflicting interests." *Golden Eagle Ins. Co. v. Foremost Ins. Co.,* 20 Cal. App.4th 1372, 1394 (1993). For independent counsel to be required, the conflict of interest must be "significant,

not merely theoretical, actual, not merely potential." *Dynamic Concepts, Inc. v. Truck Ins. Exchange,* 61 Cal. App.4th 999, 1007, 71 Cal. Rptr.2d 882 (1st Dist. 1998).

Thus, a federal district court ruled in *Rx.com v. Hartford Fire Ins. Co.,* 2006 U.S. Dist. LEXIS 18811 (S.D. Tex. March 29, 2006) that not every reservation of rights creates a conflict of interest and that an insured's right to retain counsel of its own choosing only arises where the conflict is of such a nature that "the facts to be adjudicated in the underlying liability lawsuit are the same facts upon which coverage defends such that the manner in which the case is defended can impact the ultimate availability of coverage.

Independent counsel is required, however, where there is a reservation of rights "*and* the outcome of that coverage issue can be controlled by counsel first retained by the insurer for the defense of the claim." §2860, subd. (b); *Blanchard v. State Farm Fire & Casualty Co.,* 2 Cal.App.4th 345, 350 (1991); *Truck Ins. Exchange v. Superior Court*, 51 Cal.App.4th 985, 994 (1996).

Such a conflict was found to exist in an Illinois construction defect case where the insurer had questioned whether property damage had occurred during its policy period. In *American Family Mutual Ins. Co. v. W.H. McNaughton Builders, Inc.,* No. 2-05-0063 (Ill. App. February 6, 2006), the Appellate Court ruled that the trial court had erred in finding that the insurer's reservation of rights on this basis had not created a conflict so as to warrant *Peppers* counsel. Despite the trial court's finding that there was no present conflict of interest, as both parties had an interest in obtaining a ruling that no property damage had occurred at all, the Appellate Court found that a *Peppers* conflict already existed since the insurer's interest would be served by obtaining discovery in the underlying case showing that the damage to the plaintiff's home had occurred prior to the issuance of its policies whereas it was in the insured's interest to obtain evidence that the damage occurred later.

A more nuanced approach was adopted by a federal district court in a pollution coverage case in Iowa. In *Armstrong Cleaners, Inc. v. Erie Ins. Group*, 2005 WL 774629 (S.D. Ind. March 15, 2005), the court rejected the insured dry cleaner's contention that independent counsel was required in any case in which the underlying lawsuit alleged both covered and non-covered conduct. Indeed, the court ruled that a blanket reservation of rights and a specific reservation of rights with respect to an absolute pollution did not create a conflict of interest entitling the insureds to select their own counsel both due to the inefficacy of such exclusions under Indiana law, and the fact that even if they were enforceable, they would be unlikely to be affected by the defense of the underlying lawsuit. On the other hand, the court found that such a conflict did arise from the insurer's reservation of rights with respect to the definition of "occurrence" and whether the pollution was expected or intended. While agreeing that the insured's intent was not relevant to its culpability for creating pollution in the underlying lawsuits, the court found that the insured's state of mind might be relevant in assessing the extent to which losses should be allocated among respective polluters and that if the Armstrongs were found to have intentionally polluted, they might be responsible for a higher percentage of cleanup costs than would otherwise be the case.

Nuanced Game Plans

A third approach, the **Shared Rights doctrine,** permits the insured to select counsel subject to the insurer's approval. *See Employers Fire Ins. Co. v. Beals,* 240 A.2d 397, 404 (R.I. 1968). Likewise, in states such as Florida, the insurer does not lose control of the selection of counsel in the event of a conflict but is required to appoint counsel that is acceptable to the policyholder. *Continental Ins. Co. v. Miami Beach*, 520 S.2d 232, 233 (Fla. App. 1988)(Fl. St. 627.426(2) provides that insurer and insured should jointly select "mutually agreeable" counsel).

Recognizing what is referred to as the **Enhanced Duty of Good Faith,** a few states have also declared that the insurer need not give up control of the defense but will thereafter be judged by a standard of "enhanced good faith." *L&S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.,* 521 So.2d 1298, 1304 (Ala. 1987); *Furguson v. Birmingham Fire Ins. Co.,* 460 P.2d 342, 348 (Or. 1969) and *Tank v. State Farm Fire & Casualty Co.*, 715 P.2d 1133 (Wash. 1986). Accordingly, while the insurer retains control of the defense, it must expect that its handling of the case will be closely scrutinized and that it may face extracontractual liability if its defense causes harm to the insured, as through a verdict in excess of available policy limits.

Finally, recognizing the need to **Ethically Safeguard Defense Counsel,** a few states have declared that a liability insurer that is defending its insured under a reservation of rights has no obligation to pay for independent counsel for the insured. In Hawaii, for instance, the state supreme court reversed the findings of the Hawaii Court of Appeals, which had adopted a *Cumis* approach, and instead held in *Finley v. Home Ins. Co.,* 975 P.2d 1145 (Hawaii 1998) that the best course of action is to avoid interfering with the insurer's contractual right to retain defense counsel and to leave the resolution of the conflict to the integrity and professional standards of conduct mandated for defense counsel.

A persistent issue in cases is whether an insurer has a duty to alert its insured to its legal right to seek independent counsel in the event of a conflict. A number of courts have held that there is such a duty, at least where the conflict is evident to the insurer. As the Appellate Division of the New York Supreme Court observed in *Elacqua v. Physicians' Reciprocal Insurers,* 2005 NY slip op 06538 (App. Div. August 25, 2005), that the insurer had an affirmative obligation to notify its policyholder of that right since "to hold otherwise would seriously undermine the value of this right." *But see Herbert A. Sullivan, Inc. v. Utica Mutual Ins. Co.*, 439 Mass. 837, 788 N.E.2d 522 (2003)(holding that insured would be deemed to have "acquiesced" in its insurer's selection of counsel where it failed to demand appointment of counsel of its own choosing).

Penalty Shots: Consequences of Failing to Appoint Independent Counsel

A failure to appoint independent counsel can have serious ramifications for an insurer's subsequent efforts to contest coverage.

In *Twin City Fire Ins. Co. v. City of Madison,* 309 F.3d 901 (5th Cir. 2002), the U.S. Court of Appeals for the Fifth Circuit ruled that a Mississippi District Court erred in granting summary judgment to the City's insurers on the basis of a policy exclusion, as disputed issues of fact remained with respect to whether the insurer's failure to reserve its rights on the basis of this exclusion until the eve of trial had prejudiced the insured's right to demand that independent counsel be appointed to represent its interests, such that the lower court erred in granting summary judgment to Hartford and Twin City. The court also noted with concern that the strategy advocated by defense counsel in the underlying suit, which had resulted in the court holding that the fee was a "tax," had then been relied on by the insurer in disclaiming coverage. The court found that summary judgment should not have been granted to the insurer as "a fact finder might consider that coverage analysts having unfettered access to privileged information from appointed defense counsel in the presence of an undisclosed conflict support the tort claims asserted herein." Citing the *Appleman* treatise, the Fifth Circuit said that if an insurer is defending under a reservation of rights, "the insured should be immediately notified of a possible conflict of interest between his interests and the interests of his insurance company so as to enable him to give informed consideration to the retention of other counsel."

Similarly, the Appellate Court of Illinois ruled in *Williams v. American Country Ins. Co.,* 833 N.E.2d 971 (Ill. App. 2005) that a liability insurer acted vexatiously in controlling the defense of its insured for three years and not

paying for counsel of the insured's own choosing. Despite the fact that American Country had hired separate law firms to defend its separate insureds, the court found that it should have permitted the cab driver to obtain counsel of his own choosing and that a conflict arose by reason of the fact that appointed defense counsel had filed discovery responses and pleadings stating that the cab driver was an independent contractor and not an agent of the taxicab company. The court found that a conflict of interest existed by reason of the fact that it was in the interests of the insured cab company (which shared a corporate affiliation with American Country) to avoid liability on the grounds that the cab driver, who had driven away from the scene injuring a police officer, was not its agent, whereas it would benefit the cab driver to be an agent.

Whether an insurer alerts its insured to an actual conflict, however, defense counsel has an independent ethical obligation to disclose the existence of any apparent conflict and may not proceed with the defense of the policyholder unless the conflict is resolved or the insured has given its informed consent to a waiver, where permitted.

No One Understands Offsides, or Non-Waiver Agreements

There is a lot of confusion between a reservation of rights letter and a non-waiver agreement. First, a non-waiver agreement is bilateral and must be signed and agreed to by both the insured and carrier. In contrast, a reservation of rights letter is a unilateral position statement and does not need any consent. Both, however, can be effective tools if timely and adequately implemented.

A non-waiver agreement is, in essence, an agreement that the insurer will continue to defend under a reservation of rights, or settle a matter, without waive of policy terms and defenses. Thus, contemplating resolution of the coverage matters after the underling dispute is resolved. While, technically, it affords no greater protection to an insurance company than a properly drafted reservation of rights, and it does not give an insurer absolute or unlimited protection, a non-waiver agreement can be useful to both the insurance carrier and the insured.

Carefully drafted and signed by both parties, a non-waiver agreement should make planning and business objectives for an insured clearer. The insured can begin planning for coverage litigation, reallocating resources to account for a potentially uninsured liability exposure, if necessary, and retain coverage counsel to participate, but not control, a defense.

The Post Game Presser

When a reservation of rights is in play, a pure "win" isn't always possible. Sometimes, an insurer pays for a defense of claims or damages that, for the most part, are not covered. Being defended under a reservation can leave an insured vulnerable to liability for losses not encompassed within the coverage, and often that exposure can be significant.

Recognizing both parties' interests and duties is the critical first step to working towards a resolution each can live with. Most often, the "tie" we live with is a settlement in which the insured contributes some indemnity money to settle and the insurer does not seek reimbursement of defense costs. The insured gets the benefit of the defense and contribution assistance for a potentially uninsured exposure; the carrier receives the benefit of contribution assistance on indemnity and cuts off further defense costs. Both parties save themselves the costs and challenges that come with a risky verdict, appellate costs and fees, and protracted coverage litigation.

The resulting post-game press conference isn't too interesting, but it does allow for finality and moves the

parties on to the next match week. We look forward to meeting you in Puerto Rico and visiting about your experiences, successes, and challenges with reservations of rights. Joining us will be valued colleagues from both sides of the pitch—the insured and the insurance company. See you soon!