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Narrative

When Frenemies Unite: Working with Independent Defense Counsel to Ensure Good Faith Claims Handling

Insurance law in most states requires a liability insurance company to provide its insured with a defense against a lawsuit when the complaint or petition alleges some facts that potentially or possibly fall within the scope of the carrier's policy, regardless of whether the alleged facts are true or whether other alleged facts show non-coverage. Many states also require the insurance company to consider evidence outside of the complaint when reasonably available to insurer for the purposes of assessing this duty to defend. When the insurer determines that it may have a duty to defend but does not want to waive its insurance coverage defenses, most states allow the carrier to provide its insured with a defense against the lawsuit under a reservation of rights. The question then becomes whether the insurer or the insured gets to select that defense counsel.

Policyholders' counsel often contend that their clients should select their own defense counsel in these situations. They sometimes argue that the insurance company may not zealously defend the insured if the lawsuit is not covered by the policy, or worse yet, that defense counsel retained by the insurer may defend the case in a manner so as to shift the evidence or court rulings to make the claim less likely covered. Insurance companies, of course, vigorously deny these arguments as cynical, nonsensical and ignorant of defense counsel's required adherence to the rules of professional conduct. Yet, the question remains.

Many states have determined that when the insurer reserves its rights to later decline coverage or otherwise assert coverage defenses, the insured in some situations may be entitled to select its own independent defense counsel-- otherwise known as *Cumis* counsel in California or *Peppers* counsel in Illinois, after the famous cases that enumerated this right-- at the insurer's reasonable expense. This paper will discuss when an insured is entitled to independent defense counsel, the obligation of the carrier to pay a reasonable attorney fee and how the insurer's ability to navigate these issues can help it meet its good faith claims handling obligations.

1. When is an insured entitled to independent defense counsel, if ever?

Like most issues of insurance law, whether an insured is entitled to independent defense counsel under his or her liability policy requires a state-by-state analysis. To be clear, some states have not addressed the issue at all. Other states have considered the issue but have not provided definitive guidance on same. The states that have decided the issue generally fall within one of four camps: (1)

independent counsel is required whenever the insurer reserves rights; (2) independent counsel is required only in "conflict of interests" situations; (3) independent counsel may not be required, but the insurer may have an "enhanced" duty of good faith in providing a defense; and (4) independent counsel is not required.

In the first camp, a few states have concluded that an insured may be entitled to independent counsel at the insurance company's reasonable cost whenever the insurer reserves its rights or otherwise raises a coverage defense. *See Am. Empire Surplus Lines Ins. Co. v. Gold Coast Elevator, Inc.*, 701 So. 2d 904 (Fla. Dist. Ct. App. 1997); § 627.426(2)(b), Fla. Stat (2019); *Belanger v. Gabriel Chems., Inc.*, 787 So. 2d 559 (La. Ct. App. 2001); *see also Cunard Line Ltd. Co. v. Datrex, Inc.*, 26 So. 3d 886 (La. Ct. App. 2009); *Herbert A. Sullivan, Inc. v. Utica Mut. Ins. Co.*, 788 N.E.2d 522 (Mass. 2003); *Federated Dept. Stores, Inc. v. Twin City Fire Ins. Co.*, 807 N.Y.S.2d 62, 66 (N.Y. App. Div. 2006); *N. Cnty. Mut. Ins. Co. v. Davalos*, 140 S.W.3d 685, 689 (Tex. 2004).

For example, Florida by statute requires the insurer to retain counsel who is "mutually agreeable" to the parties whenever it reserves its rights. *See Gold Coast Elevator, Inc.*, 701 So. 2d at 906. The insured must consent to any defense counsel provided to it in this situation, effectively providing the insured with a right of independent counsel. That right may be even stronger in Massachusetts, where the Supreme Court there has held: "When a liability 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 of rights or relinquish its defense of the insured and reimburse the insured for its defense costs." *Herbert A. Sullivan*, 788 N.E.2d at 539. Similarly, where an insurer in New York defends under reservation of rights, the insured is entitled to retain its own counsel. *Federated Dept. Stores*, 807 N.Y.S.2d at 66. When counsel is assigned to defend insured, the paramount interest independent counsel represents is that of insured, not insurer, and if there is conflict of interest between carrier and insured, counsel cannot represent both. *Id.*

In addition, an insurer in New York has an affirmative obligation to advise the insured of its right to independent counsel. An insurer who fails to advise its insured that it is entitled to retain independent counsel commits a deceptive business practice under N.Y. GEN. BUS. LAW § 349. *Elacqua v. Physicians' Reciprocal Insurers,* 860 N.Y.S.2d 229, 231-32. (N.Y. App. Div. 3rd Dept. 2008); *but see Tower Ins. Co. of New York v. Sanita Const. Co., Inc.*, 129 A.D.3d 430, 431 (N.Y. App. Div. 1st Dept. 2015) (right to independent counsel does not establish an affirmative duty to advise insured of that right).

In the second camp, a majority of states have held that an insured is entitled to independent counsel at the insurance company's reasonable cost only if the coverage issue or defense raised by the insurer would present a "conflict of interest" in the defense of the underlying case. *See e.g.* Alaska Stat. § 21.96.100; Cal. Civ. Code § 2860; *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc.*, 208 Cal. Rptr. 494 (Ct. App. 1984); *Maryland Cas. Co. v. Peppers*, 64 Ill.2d 187 (Ill. 1976); *Bell v. Tilton*, 674 P.2d 468 (Kan. 1983); *Brohawn v. Transamerica Ins. Co.*, 347 A.2d 842 (Md. 1975); *Mut. Serv. Cas. Ins. Co. v. Luetmer*, 474 N.W.2d 365 (Minn. Ct. App. 1991); *State Farm Mut. Auto. Ins. Co. v. Hansen*, 357 P.3d 338 (Nev. 2015); *Morrone v. Harleysville Mut. Ins. Co.*, 662 A.2d 562, 567 (N.J. Super. Ct. App. Div. 1995); *Lusk v. Imperial Cas. & Indemn. Co.*, 603 N.E.2d 420 (Ohio Ct. App. 1992); *Nisson v. Am. Home Assur. Co.*, 917 P.2d 488 (Okla. Civ. App. 1996); *St. Paul Fire & Marine Ins. Co. v. Engelmann*, 639 N.W.2d 192 (S.D. 2002).

Exactly what constitutes a "conflict of interest" differs from state to state under these tests. For example, Illinois courts have held that a conflict may exist when "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." *Nandorf, Inc. v. CNA Ins. Cos.,* 134 Ill.App.3d 134 (Ill. App. Ct. 1985). While an "insurer's interest in negating policy coverage does not, in and of itself, create sufficient conflict of interest to preclude the insurer from assuming the defense of its insured," Illinois courts have said that a "conflict of interest has been found where the underlying action asserts claims that are covered by the insurance policy and other causes which the insurer is required to defend but asserts are not covered by the policy." *Id.* New York courts have found a conflict only in "cases where the defense attorney's duty to the insured would require that he defeat liability on any ground and his duty to the insurer would require that he defeat liability only upon grounds which would render the insurer liable." *Goldfarb*, 425 N.E.2d 810 (N.Y. 1981). Ohio courts have explained that a conflict may exist when an "insurer might believe that its insured's conduct constitutes excluded conduct under an insurance policy" and "it may be to the insurer's financial advantage to see" through defense of the case "that the conduct is excluded, thus precluding indemnification." *Dietz-Britton v. Smythe, Cramer Co.*, 743 N.E.2d 960 (Ohio Ct. App. 2000).

Even when a state's conflict rule is understood, application of that rule to the alleged facts of a particular lawsuit may not be the most straightforward endeavor. It is easy to find a conflict where the plaintiff alleges that the insured's conduct that caused bodily injury was negligent in one count of the complaint (and thus likely covered by the policy) and intentional in another count (and thus less likely covered). *See Peppers*, 64 Ill.2d 187. But what about a suit in which punitive damages are sought? By statute, some states have said no conflict. *See* Alaska Stat. § 21.96.100(b); Cal. Civ. Code § 2860(b). Other states, however, have suggested that a claim for punitive damages could create a conflict of interest if there is a large disparity between the amounts sought for compensatory and punitive damages. *See e.g. Nandorf, Inc. v. CNA Ins. Cos.,* 134 Ill.App.3d 134 (Ill. App. Ct. 1985). A similar issue exists when the lawsuit seeks damages in excess of the policy limits.

Similar to the New York rule, many jurisdictions in these conflict-of-interest states require the insurer to inform the insured of its right to independent counsel and to outline the potential conflicts. *See* Cal. Civ. Code § 2860(a); *Am. Family Mut. Ins. Co. v. Westfield Ins. Co.*, 962 N.E.2d 993 (Ill. App. Ct. 2011); *Brohawn*, 347 A.2d at 845. The failure to do so may result in the insurer's loss of its coverage defenses. *See id.*

In the third camp, a few states have decided that an insured may not be entitled to independent counsel at all when the insurance company reserves its rights. However, many of the states in this camp impose an "enhanced" duty of good faith upon the insurer in the provision of the insured's defense with the insurer's appointed counsel. *See e.g. Lifestar Response of Alabama., Inc. v. Admiral Ins. Co.*, 17 So. 3d 200 (Ala. 2009); *L & S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298 (Ala. 1987); *Finley v. Home Ins. Co.*, 975 P.2d 1145 (Haw. 1998); *Johnson v. Cont'l Cas. Co.*, 788 P.2d 598 (Wash. Ct. App. 1990); *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133 (Wash. 1986).

The "enhanced" duty of good faith was explained by the Washington Supreme Court as follows:

> This enhanced obligation is fulfilled by meeting specific criteria. First, the company must thoroughly investigate the cause of the insured's accident and the nature and severity of the plaintiff's injuries. Second, it must retain competent defense counsel for the insured. Both retained defense counsel and the insurer must understand that only the *insured* is the client. Third, the company has the responsibility for fully informing the insured not only of the reservation-of-rights defense itself, but of *all* developments relevant to his policy coverage and the progress of his lawsuit. Information regarding progress of the lawsuit includes disclosure of all settlement offers made by the company. Finally, an insurance company must refrain from

engaging in any action which would demonstrate a greater concern for the insurer's monetary interest than for the insured's financial risk.

Tank, 715 P.2d at 1137. Thus, insurance companies that retain defense counsel for their insureds in these reservation-of-rights situations should tread very carefully in these particular states.

Finally, a smaller group of states appear to have concluded that the insured may not be entitled to independent counsel at all in these situations. *Barefield v. DPIC Cos., Inc.*, 600 S.E.2d 256 (W. Va. 2004); *Richmond v. Georgia Farm Bureau Mut. Ins. Co.*, 231 S.E.2d 245 (Ga. Ct. App. 1976). The rationale here is that any defense counsel retained by the insurer would owe professional obligations to the insured, and thus appointment of independent defense counsel would be unnecessary. Of course, Georgia does suggest that the insurer should seek a stay of the underlying case while coverage may be determined in a separate action. *See Richmond*, 231 S.E.2d at 248.

2. What kind of fee does the insurer have to pay independent defense counsel?

Perhaps the biggest sticking point between the insured and insurer when the insured is entitled to independent defense counsel is the fee that independent counsel may collect from the insurance company. With some exceptions, the legal authorities on the fees owed by the insurer in this situation are a little thin. Some states by statute require the insurer to pay only a fee in accordance with a rate actually paid by the insurer to an attorney in the ordinary course of business in the defense of a similar civil action in the community in which the claim arose or is being defended. *See e.g.* Alaska Stat. § 21.96.100(d); Cal. Civ. Code § 2860(c). Other states by court decision provide that independent defense counsel's fee must be "reasonable." *See e.g.* § 627.426(2)(b)(3), Fla. Stat (2019); *Int'l Ins. Co. v. City of Chicago Heights*, 643 N.E.2d 1305 (Ill. App. Ct. 1994); *Magoun v. Liberty Mut. Ins. Co.*, 195 N.E.2d 514 (Mass. 1964); *Prahm v. Rupp Const. Co.*, 277 N.W.2d 389 (Minn. 1979); *Moeller v. Am. Guar. & Liab. Ins. Co.*, 707 So. 2d 1062, 1069 (Miss. 1996); *Pub. Serv. Mut. Ins. Co. v. Goldfarb*, 425 N.E.2d 810, 815 (N.Y. 1981); *Socony-Vacuum Oil Co. v. Cont'l Cas. Co.*, 59 N.E.2d 199 (Ohio 1945). If no agreement can be reached, a Florida statute allows the court to set the fees. *See* § 627.426(2)(b)(3), Fla. Stat (2019). In Alaska, they may be set by arbitration. *See* Alaska Stat. § 21.96.100.

3. How can an insurer meet its good faith claims handling obligations with independent counsel?

Some states take a very expansive view of bad faith. For example, the Florida Supreme Court recently explained that bad faith law was "designed to protect insureds who have paid their premiums and who have fulfilled their contractual obligations by cooperating fully with the insurer in the resolution of claims." (citations omitted). *Harvey v. GEICO Gen. Ins. Co.*, 259 So.3d 1 (Fla. 2018). Bad faith jurisprudence "merely holds insurers accountable for failing to fulfill their obligations." *Id.* In Florida, in handling the defense of claims against its insured, the insurer has a duty to use the same degree of care and diligence as a person of ordinary care and prudence should exercise in the management of his own business." *Id.* This duty arises from the nature of the insurer's role in handling the claim on the insured's behalf—because the insured "has surrendered to the insurer all control over the handling of the claim, including all decisions with regard to litigation and settlement, then the insurer must assume a duty to exercise such control and make such decisions in good faith and with due regard for the interests of the insured." *Id.*

This good faith duty in Florida obligates the insurer to advise the insured of settlement opportunities, to advise as to the probable outcome of the litigation, to warn of the possibility of an excess

judgment, and to advise the insured of any steps he might take to avoid same. *Id.* at 6-7. The insurer must investigate the facts, give fair consideration to a settlement offer that is not unreasonable under the facts, and settle, if possible, where a reasonably prudent person, faced with the prospect of paying the total recovery, would do so. Because the duty of good faith involves diligence and care in the investigation and evaluation of the claim against the insured, the Florida Supreme Court in *Harvey* has held that *negligence* is relevant to the question of good faith. *Id.* at 7. The critical inquiry for bad faith in Florida is whether the insurer diligently, and with the same haste and precision as if it were in the insured's shoes, worked on the insured's behalf to avoid an excess judgment. *Id.*

On the other hand, some states take a narrower view of bad faith. For example, the New York Supreme Court recently held that to establish bad faith in failing to settle a liability claim in that state, the insured must show that "the insurer's conduct constituted a 'gross disregard' of the insured's interests – that is, a deliberate or reckless failure to place on equal footing the interests of its insured with its own interests when considering a settlement offer." *Healthcare Professionals Ins. Co. v. Parentis*, 165 A.D.3d 1558 (N.Y. App. Div. 2018). Put another way, the plaintiff must establish that the defendant insurer engaged in a "pattern of behavior evincing a conscious or knowing indifference to the probability than an insured would be held personally accountable for a large judgment if a settlement offer within the policy limits were not accepted." *Id.* It must be shown that "the insured lost an actual opportunity to settle the claim at a time when all serious doubts about the insured's liability were removed." *Id.* The court must consider all the facts and circumstances in gauging whether an insurer acted in bad faith in addressing settlement. *Id.* Key factors include the plaintiff's likelihood of success, the potential magnitude of a verdict and the corresponding financial burden on the insured and the information available to the insurer at the time the settlement demand was made. *Id*. at 1559-60.

In terms of the insured's defense counsel, allowing the insured to retain independent defense counsel at the insurer's reasonable expense-- where warranted under the applicable state law-- certainly takes any steam away from the argument that the carrier put its interests ahead of the insured's. It will be difficult for the insured to argue that the insurer improperly tried to shift the defense of the case towards non-coverage when the insured was allowed to select its own defense counsel. To that end, some case law suggests that that the insurer may not need to bifurcate its claims file into separate defense and coverage files when independent defense counsel is retained. *See State Farm Fire & Cas. Co. v. Superior Court*, 216 Cal.App.3d 1222 (Ct. App. 1989); *Armstrong Cleaners, Inc. v. Erie Ins. Exchange*, 364 F.Supp.2d 797 (S.D. Ind. 2005). Again, the rationale is that independent defense counsel will adequately protect the insured's interests in light of the coverage issues. Moreover, as discussed above, in those jurisdictions where independent defense counsel is required, actually following the law on this issue will further demonstrate that the insurer intended to handle the claim in good faith.