2015 CLM Annual Conference

Palm Desert

The Cumis Conundrum

Presenters: Kathleen Bragg-Pebley, *Momentus Insurance Brokerage*
David Datny, *Lewis Brisbois Bisgaard & Smith, LLP*
Peter Loughlin, *Assurant Specialty Property*
Raymond Tittmann, *Edison, McDowell & Hetherington LLP*

I. The Origins of "*Cumis*": It's All About Ethics

A. The Tripartite Relationship: Defense Counsel Represents Insurer and Insured

As everyone knows, when an insurer agrees to defend an insured, appointed defense counsel becomes counsel to both the insured an the insurance company. Defense counsel has two clients. This is called the "tripartite relationship."

As explained in the *Cumis* doctrine's namesake case, *San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal. App. 3d 358 (1984), in the usual tripartite relationship, there is a single, common interest shared among them. Dual representation by counsel is beneficial since the shared goal of minimizing or eliminating liability to a third party is the same.

A different situation is presented, however, when some or all of the allegations in the complaint do not fall within the scope of coverage under the policy. In such a case, the standard practice of an insurer is to defend under a reservation of rights. Although issues of coverage under the policy are not actually litigated in the third party suit, this does not detract from the force of these opposing interests as they operate on the attorney selected by the insurer, who has a dual agency status.

The concern is heightened when, as is usually the case, the insurer's attorneys have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured.

B. The Rules of Ethics

In short, the insurer and insured's disparate interests mean that defense counsel is representing two clients with conflicting interests.

An attorney having dual agency status is subject to the rule a conflict of interest between jointly represented clients occurs whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other.

No matter how honest the intentions, counsel cannot discharge inconsistent duties.

This conflict of interest between clients squarely raises an ethical issue independent of the

parallel insurance issues.

The ABA Code Ethical Considerations 5–1 provides:

"The professional judgment of a lawyer should be exercised, within the bounds of the law, solely for the benefit of his client and free of compromising influences and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client."

ABA Code Ethical Considerations 5–15 provides:

"If a lawyer is requested to undertake or to continue representation of multiple clients having potentially differing interests, he must weigh carefully the possibility that his judgment may be impaired or his loyalty divided if he accepts or continues the employment. He should resolve all doubts against the propriety of the representation. A lawyer should never represent in litigationmultiple clients with differing interests;19 and there are few situations in which he would be justified in representing in litigation multiple clients with potentially differing interests. If a lawyer accepted such employment and the interests did become actually differing, he would have to withdraw from employment with likelihood of resulting hardship on the clients; and for this reason it is preferable that he refuse the employment initially. On the other hand, there are many instances in which a lawyer may properly serve multiple clients having potentially differing interests in matters not involving litigation. If the interests vary only slightly, it is generally likely that the lawyer will not be subjected to an adverse influence and that he can retain his independent judgment on behalf of each client; and if the interests become differing, withdrawal is less likely to have a disruptive effect upon the causes of his clients."

Therefore, the "*Cumis*" doctrine is at its core an ethics doctrine that applies equally to any attorney-client relationship involving clients with conflicting interests.

C. The "*Cumis*" Case and Statutory Sources

As mentioned, the term of art, "Cumis counsel" arises out of the leading case *San Diego Navy Federal Credit Union v. Cumis Ins. Society, Inc.*, 162 Cal. App. 3d 358 (1984). Jurisdictions other than California may simply refer to this instead as "independent counsel."

Though the reference is generally understood as an insurance doctrine, it is really simply an application of existing ethics rules concerning conflict of interest. The court in *Cumis* simply applied existing ethics rules to find that defense counsel appointed by the insurer cannot represent both the insurer and the insured when the insurer's reservation of rights creates a conflict of interest.

Nevertheless, the *Cumis* case did discuss a few nuances that are particular to the insurance context. First, the court explained that the conflict of interest is not easily waived. The court in *Cumis* found that 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.

Second, the court in *Cumis* found that the obligation to fund separate independent counsel falls to the insurer. The insurer may not compel the insured to surrender control of the litigation or force

the insured to fund its own defense.

After the *Cumis* decision in 1984, the California Legislature responded by enacting California Civil Code §2860. This was the first attempt by a state legislature to address insurance defense conflicts of interest through legislation.

Section 2860 largely adopts *Cumis*, though it did add certain protections for insurance companies, discussed below.

II. Defense Counsel Concerns in *Cumis* Conflicts

A. Independent Obligation To Assess Conflicts – and Reassess

Defense counsel must first and foremost recognize that the *Cumis* doctrine arises out of counsel's ethical obligations, not the insurance company's obligations. California Rules of Professional Conduct rule 5–102(B), for example, states: "A member of the State Bar shall not represent conflicting interests, except with the written consent of all parties concerned."

Because defense counsel is retained (1) by the insurance company and (2) to litigate the underlying case rather than coverage, it is no doubt tempting simply to rely on the insurance company's decision whether to appoint independent counsel. Defense counsel may treat *Cumis* as a "coverage question" resolved by the insurance company and its coverage counsel, not to be questioned by defense counsel.

However, it is equally if not primarily defense counsel's ethical obligation to assess the conflict. Counsel cannot simply jump into the litigation without independent assessing its own ethical obligations.

Moreover, *Cumis* cases distinguish potential conflicts and actual conflicts. While every reservation of rights might arguably create a potential for conflict between the insured and insurer, courts are clear in stating that only actual conflicts require independent counsel. Therefore defense counsel should not only assess conflicts from the outset, he or she should continue to reassess to determine if discovery or legal theories evolve in such a way that turns a potential conflict into an actual conflict.

B. Clarifying the Assignment: Who Is Your Client and What Is Your Goal?

To meet its ethical obligations, defense counsel should start by clarifying its assignment, goals, legal theories, relevant facts, and likely discovery. For example, coverage may turn on the timing of the injury. If the timing of the injury is undisputed, this might not create an actual conflict. However, if discovery emerges that puts the timing at issue, a theoretical conflict may become actual. Similarly, if the insurance company instructs defense counsel to conduct discovery as to the timing of injury, that may create a conflict.

It is a difficult task because defense counsel is forced, in some ways, to understand the coverage issues that might give rise to the conflict. However defense counsel has no choice but to take these steps and even challenge its insurance company clients in order to meet its ethical obligations.

C. Reporting: to Insurance Company and the Insured

In the tripartite relationship, defense counsel also needs to communicate and report to both clients, insurance company and insured. A record of reporting to the insurer and not the insured raises serious concerns about whether it is meeting its ethical obligations to both clients.

Likewise, if coverage-related discovery emerges, defense counsel should be careful not to withhold information from one of its clients. Any effort to discuss such developments with one client but not the other raises significant ethical concerns.

D. Arguing Coverage Issues for the Insured Risks Creating a Conflict

The panelists are concerned with the frequency at which defense counsel, or attorneys asking to be named defense counsel, do not hesitate to argue coverage issues with the insurance company. Typically this occurs when the insured's personal counsel is arguing to the insurer that it should accept coverage and appoint that personal counsel as defense counsel. If the insurer subsequently accepts the defense and determines that the reservation of rights does not create an intrinsic conflict requiring appointment of *Cumis* counsel, defense counsel may have effectively conflicted itself from being appointed defense counsel in the tripartite relationship by making itself adverse to the insurance company.

E. Resolving Cases that Treat Co-Insureds or Additional Insureds Differently

Conflict situations can become especially complicated in the context of settlement discussions, when an allocation dispute arises between the insured and insurer or between co-insureds or additional insureds. In that scenario, defense counsel either needs to obtain a waiver of such conflicts with informed written consent or separate counsel should be appointed. Though interests may be unified towards defeating liability through litigation, settlements that treat clients differently can suddenly raise complicated ethical situations. Similar situations may arise when motions are filed to dismiss some but not all clients.

To illustrate, automobile accident cases often require defense counsel to represent both the owners/lessors of vehicles and the drivers. The potential conflict occurs when counsel seeks dismissal on behalf of the owner under the Graves Amendment, which results in the driver remaining in the case. By doing this, counsel advocates in favor of the owner and essentially forgoes arguing for the driver any defects with the vehicle. Case law has suggested there is an inherent conflict of interest in representing these parties, but as a matter of course carriers appoint one firm.

F. Privilege in the Tripartite Relationship

Once the insurer accepts defense, the attorney-client privilege extends to conversations and correspondence between the insurer and the attorney. *American Mut. Liab. Ins. Co. v. Sup. Ct. (Nork)*, 38 Cal. App. 3d 579 (1974). However, the attorney's problems do not end there. Although status reports can be circulated to the insurer and insured without waiving any privileges or protections, the attorney still is obligated to maintain confidential information obtained directly from the insured and the insurer. What this means is that if the insurer discloses confidential information to the attorney, the attorney may not disclose that information to the insured.

Similarly, an attorney may not disclose confidential information obtained from an insured to the insurer even if the confidential information proves that the insured is actually not entitled to coverage. *Id.* at 592. In fact, a recent California State Bar Formal Opinion held that this is true

even if the counsel discovers that the insured has fraudulently made it appear coverage exists. In that situation, however, the attorney would have to withdraw because of the conflict of interest that knowledge would create.

III. Insurer Concerns in *Cumis*?

A. Reserving Rights: When Not To Reserve

When presented with a duty to defend question, outside and corporate coverage counsel must remember to not limit the analysis to the duty to defend, but to add *Cumis* issues to the analysis. *Cumis* issues are not "extra," they are essential. Because *Cumis* issues are not presented in the initial assignment, this is easy to forget.

Therefore, a proper coverage analysis should not stop with the duty to defend, but should consider what coverage defenses are most likely to determine future indemnity obligations; whether those defenses present an actual conflict requiring independent counsel; and if so whether the benefits of reserving rights justify the additional costs and complications of reserving those rights.

Cumis counsel is not simply a matter of paying an attorney chosen by the insured. Often times the *Cumis* counsel can become hostile to the insurance company, withhold reporting, seek to create or maximize coverage, run of litigation costs, etc. Litigation is expensive and burdensome enough, but when counsel has no incentive to handle or resolve efficiently because someone other than the client is paying the bills, it can become downright oppressive. We have frequently seen this in the environmental context where the Plaintiff and the insured may have a unified interest in driving up remedies because they are both benefitting from the cleanup, and so the two conspire with their counsel and experts to force more money out of the insurance companies. In effect, the insurance company ends up paying its opposition.

Given these concerns, insurance companies should only reserve rights if the reservation that creates the conflict is credible enough to justify the increased costs.

Moreover, if there are any doubts about the fairness of *Cumis* counsel's handling of the litigation, the insurance company should probably retain its own counsel to represent the insured, as is its right.

B. In Most States, Not Every Reservation Creates a Conflict

Policyholder coverage counsel often repeat the mantra that a reservation of rights by definition creates a conflict. That is not true in most states. An insured seeking independent counsel must show that the issue reserved is actually at issue in the underlying litigation. A general reservation or the potential for a conflict do not alone trigger *Cumis*.

Under Section 2860, for example, a conflict of interest does not arise simply because an insurer has reserved its rights. The insurer's reservation of rights must create a conflict that is "significant, not merely theoretical, actual, not merely potential." A claim for punitive damages or a claim in excess of policy limits does not create a conflict of interest under this statute. A conflict of interest may only arise when an insurer reserves its rights with respect to an insurance coverage issue, the outcome of which can be controlled by defense counsel.

However, some states do follow a “per se” rule providing that any reservation of rights create a conflict justifying independent counsel. *See e.g. Medical Protective Co. v. Medical Protective Co.*, 581 S.W.2d 25, 26 (Ky. 1979); *Rhodes v. Chicago Ins. Co.*, 719 F.2d 116, 120-121 (5th Cir. 1983); *United Services Auto Assn. v. Morris*, 741 P.2d 246, 252 (Ariz. 1987); *Moeller v. American Guarantee & Liab. Ins. Co.*, 707 So.2d 1062, 1069 (Miss. 1996).

Florida Statutes §627.426(2), for example, assumes a conflict of interest whenever the insurer reserves its right to deny coverage. It is therefore much closer to the "per se" approach.

The Florida statute gives the insurer only two options when the insurer elects to reserve its right to deny coverage: (1) the insurer may 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) the insurer may retain "independent counsel which is mutually agreeable to the parties." For all practical purposes, therefore, the Florida statute entitles the policyholder to independent counsel in most instances where the insurer reserves its right to deny coverage.

C. Advising of the Right to *Cumis*

Most states oblige the insurance company to assess conflicts and advise the insured of the right to independent counsel. Washington is a little different, as it permits the insurer to select independent counsel and then advise that counsel to represent the interests of the insured.

D. Ability to Control Rates

Generally, the insurer is only obliged to pay customary rates in light of the jurisdiction and subject matter, and insist on sufficient experience of the chosen counsel. If the insured prefers other counsel the insured must pay the difference.

For example, California’s Section 2860 provides that an insurer is only obligated to pay independent counsel "the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended." Insurers also have the right to require that independent counsel carry errors and omissions insurance, and possess "substantial defense experience in the subject area of the litigation." Further, any dispute regarding the amount of fees owed to independent counsel must be resolved though binding arbitration.

In order to protect itself of later challenges to customary rates, insurers are compelled to hold the line on rates, making no exceptions.

E. When the Insured Does Not Request *Cumis*

The insured may decline its right to *Cumis* counsel despite a conflict of interest. However, because the doctrine is rooted in rules of ethics, both the insurance company and defense counsel should ensure that the insured signs a written waiver with full disclosure, advising the insured to be advised by independent counsel with respect to the waiver.

F. Additional Insured Complications

Additional insureds claiming defense rights under a Policy can create extremely complicated conflicts. Typically, this occurs when the insured and the additional insured are both sued (e..g,

if a subcontractor's liability policy protects the general contractor as an additional insured). In addition to the possible conflict between the insurer and named insured, the named insured ("defendant") and additional insured ("co-defendant") are conflicted. The co-defendant might also be covered by its own policy.

This can create a complicated matrix of defense counsel: both the defendant and the co-defendant are entitled to *Cumis* counsel, and the insurer is entitled to appoint its own defense counsel as well to defend its insureds. Then, if the co-defendant is also covered, its insurance company might also appoint counsel for the co-defendant.

The two defendants could wind up being represented by six attorneys.

To simply this situation, insurers and the defendants should find a way to work together, for example by waiving conflicts or entering joint defense defense agreements wherein they agree to contest liability together, perhaps reserving rights on allocation of ultimate liability.

G. Appointing Insurer Defense Counsel To Defend Alongside *Cumis*

Civ. Code § 2860(f) provides that defense counsel must be permitted to participate in all aspects of the litigation. This can be confusing as this can result in two attorneys appearing as counsel of record for the insured in a single action. Moreover, when these counsel disagree on strategy, the situation can be even more confusing.

Deciding whether to appoint insurer counsel to represent the insured along with the *Cumis* counsel therefore presents a difficult analysis and is dependent on the context. When there is a significant conflict, and therefore opportunity for defense counsel to affect coverage, we recommend appointing insurer counsel. We have seen too many occasions in which independent defense counsel has disadvantaged the insurer and driven up fees in the process.
At the same time, because of the complications created by having one party represented by two counsel, the insurer and its counsel should do everything possible to maintain a cooperative and amicable relationship.

In the end, however, we believe the insurer retains the right to control the defense. This is based upon the standard language in general liability policies, which typically grant to the insurer "the right and duty to defend any suit" and also permit insurers to "make such investigation and settlement of any claim as it deems expedient." The insured has the corresponding obligation to cooperate in the defense. *Spindle v. Chubb/Pacific Indemnity Group*, 89 Cal.App.3d 706, 710 (1979); *Gafcon, Inc. v. Ponsor & Associates*, 98 Cal.App.4th 1388, 1406-1407 (2002).

IV. Evolving Issues in *Cumis*

A. California Supreme Court Reviewing Insurer's Right To Sue *Cumis* Counsel for Excessive Billing (*J.R. Marketing v. Hartford Casualty Insurance Company*)

In its ruling in *J.R. Marketing v. Hartford Casualty Insurance Company*, the California Court of Appeal ruled that an insurer is barred from maintaining a direct action against an independent counsel (*Cumis* counsel) for reimbursement of excessive fees charged by the independent counsel in mounting an insured's defense. Instead, the insurer's only recourse is to bring an action for reimbursement against the insured. On September 18, the California Supreme Court announced that it has accepted Hartford's petition for review of the Court of Appeal's ruling.

B. **Denial of Defense Waives Right To Contest Defense Bills and Rates Later (*City Art, Inc. v. Superior Court*)**

On December 9, 2014, the California Court of Appeal ruled in an unpublished decision that Travelers could not retroactively apply statutory rate limitations to attorneys' fees of *Cumis* counsel incurred before Travelers started paying the company's independent counsel. *City Art, Inc. v. Superior Court*, No. B256132, 2014 WL 6907582, at *1 (Cal. Ct. App. Dec. 9, 2014).

Travelers initially denied a duty to defend to City Art Inc. before later agreeing to pay fees for the company's independent counsel. The insurer can only take advantage of rate limitations under California Civil Code Section 2860 after it begins providing a defense under a reservation of rights. The appellate opinion reversed a lower court's ruling in favor of the insurer.

"An insurer that breached the duty to defend must make its insured whole with respect to defense costs reasonably incurred; an insured should not be left with partial recovery simply because the insurer would have had a conflict of interest requiring it to provide independent counsel, had the insurer accepted its duty to defend."

Decisions such as this put pressure insurers to accept the defense early in order to secure its ability to limit the rates. Courts seem to be leaning towards a holding that insurance companies waive rights when they delay accepting a defense.

***

Disclaimer: This is not written or approved by, and shall not be attributed to, each of the panelists or their employers; as different parts were written and informed by different people and different sources, without uniform review or consent.