CLM CLAIMS & LITIGATION MANAGEMENT ALLIANCE™

ADVANCING ETHICS, COOPERATION AND EDUCATION

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501 E. Camino Real
Boca Raton, FL 33432

Roundtable 1: Thursday, April 10, 2014 (10:10 am – 11:10 am)

Walk the Line: Ethics for Insurance Carrier – Selected Defense Counsel

In recent years, there have been significant changes in the way insurance carrier selected defense counsel represent their insureds who have been sued for alleged tortious conduct. This round table will provide a brief introduction about who the "client" is, what needs to be told to the insured at the beginning of the representation, how to work with the adjustor, watching for and reacting to the possible divergence of interests between the insured and the insurance carrier and excess exposure issues. These topics will be explored through a series of hypotheticals.

1. Who is the Client?

- **Tripartite relationship**

  In a number of states, defense counsel, the insured and the carrier are all three parts of what is commonly referred to as the "tripartite" relationship which simply means that both the insured and the carrier are the "client."

  Other states follow the "one-client" rule where only the insured is viewed as the client. In those states, one of the theories behind this concept is that if both the insured and the carrier are the "client," the relationship between the insured and defense counsel is weakened because of the competing interest of the carrier.

  Most, if not all, of the cases in which a carrier is paying defense counsel to defend the insured pursuant to the terms of an insurance contract purchased by the insured and the lines are blurred in this three-way relationship regardless of whether the insured is in a "tripartite" state or a "one-client" state.

- **Duties to the insured and the carrier**

  Because the insured is a client (and regardless of whether the carrier is also a client), defense counsel owes the insured a duty of undivided loyalty. In most cases, this does not present a problem because the carrier's interests are fully consistent with those of its insured – to defeat or settle the claim brought against the insured by a third party. If the matter reaches litigation,

defense counsel appears on behalf of the insured and at all times represents the insured in terms measured by the extent of his retention.

The duty of undivided loyalty means defense counsel may do nothing that injures the interests of the insured without the informed consent of the insured. Defense counsel cannot assist the carrier in defeating coverage as such assistance would breach the duty of undivided loyalty to the insured.

- **What if they conflict or potentially conflict? (coverage issues, fraud by the insured)**

If representing the insured and the carrier jointly would create a conflict of interest, then joint representation is impermissible, absent informed written consent from both the insured and the carrier. Otherwise, independent counsel representing only the carrier must be paid for by the insurer to discharge its duty to defend.

2. What Does Defense Counsel Need to Tell the Insured at the Outset of the Representation?

- **The role of defense counsel and that defense counsel cannot give coverage advice to insured**

Pursuant to Rule 1.4 of the ABA Model Rules of Professional Conduct, defense counsel shall keep the insured informed, consult with the insured about the means by which the insured's objectives are to be accomplished, promptly comply with reasonable requests for information, consult with the insured on the relevant limitations on the lawyer's conduct and explain a matter to the extent reasonably necessary to permit the insured to make informed decisions.

- **Identify potential coverage issues and advise to retain separate coverage counsel (if appropriate)**

A material limitation exists when a lawyer cannot consider, recommend or carry out an appropriate course of action for the insured because of the lawyer's other responsibilities or interests – arguably to the carrier. In applying this standard to insurance representations, courts have demanded special sensitivity to any situation where the choices made by defense counsel could benefit the carrier at the insured's expense.

3. Working With the Carrier

- **What are the carrier guidelines and reporting requirements?**

Under ABA Model Rule 1.4, defense counsel maintains a duty to communicate all information relevant to the underlying claim to both the insured and the carrier. The specifics of the communications and required information are generally defined by carrier guidelines. For example, the necessary substance and timing of status reports, along with preapproval for depositions, expert retention, research, motions and attendance at various events. In addition, Model Rule 1.4 requires counsel to respond to carrier inquiries as soon as reasonably possible. In 2012, this requirement was extended to include not only telephone calls and letters but also e-mails.

- **Are status reports to the carrier privileged and should the insured be copied on said reports?**

Status reports are the primary tool for communicating with the carrier. But, surprisingly, according to the ABA, status reports are not necessarily privileged. In claims in which the carrier maintains the right to control the litigation but there is no reservation of rights, status reports are considered privileged communications. However, if there is a reservation of rights, status reports are potentially discoverable. In these instances, courts will determine whether a clear tripartite relationship, one in which the insured and the carrier have a common interest, exists. In addition, courts will consider factors such as selection of counsel and payment of legal bills. If the carrier selects the defense counsel and pays the defense counsel's legal bills, status reports are treated as privileged communications.

4. <u>Watching for and Reacting to Possible Divergence of Interests Between Insured and Carrier</u>

- **What if defense counsel learns facts that could impact the insurer's coverage of the subject claim?**

Under ABA Model Rule 1.6, defense counsel is obligated to maintain the confidences of the insured. However, because most insurance policies give the carrier the right to control the litigation, there is implied consent from the insured for defense counsel to disclose claim information to the carrier through status reports and legal bills. In some instances, however, disclosure may result in a conflict of interest. Just because the carrier controls the litigation or pays the legal bills, disclosure is not automatically authorized. For example, defense counsel must obtain the policyholder's informed consent to disclose any materially adverse information, such as that which would limit or preclude coverage, to the carrier. Informed consent means the information and material risks of disclosure must be explained and discussed with the insured and reasonably available alternatives to disclosure must be explored.

If the insured refuses to consent to disclosure to the carrier, there is a conflict. Furthermore if the carrier has asked for and truly requires the confidential information, defense counsel must withdraw.

In California, the State Bar issued a formal opinion stating that defense counsel has a duty to protect adverse coverage information from disclosure to a carrier.

- **What if the insured does not agree with the carriers about the case handling strategy and settlement authority?**

Most courts hold that the insured relinquishes control of its defense when it executes the cooperation clause and accepts representation by counsel. But a carrier's strategic directive cannot impede defense counsel's ability to competently and effectively represent the insured. If defense counsel receives a strategic directive from the carrier, defense counsel should consider whether she can follow the directive without violating the duty of competent representation. These issues often arise in relation to litigation and billing guidelines (i.e. - limiting the number of depositions or requiring prior approval for legal research or motions). In these instances, defense counsel is required to proceed in the best interest of the insured. As a result, if there is a disagreement between defense counsel strategy and carrier strategy, defense counsel should disclose the disagreement to the insured and then approach the carrier about the disagreement and the options for resolution. If the disagreement if unresolvable in a manner that would protect the insured's interests, there is a conflict and defense counsel must withdraw.

Under ABA Model Rule 1.2, defense counsel must honor the insured's decisions about settlement. However, under most insurance policies, the insured relinquishes the right to make

decisions about settlement and the carrier is authorized to settle a claim without the insured's consent. The insured does, however, retain the power to reject the defense and assume the risk and expense of its own defense. So, if the insured disagrees with the claim handling strategy or the authorization for settlement by the insurer, defense counsel should give the insured the opportunity to reject the settlement and terminate the representation.

5. Conflicts of Interest

- **When does a concurrent conflict of interest exist and when is it prohibited?**

Pursuant to Rule 1.7 of the ABA Model Rules of Professional Conduct, a concurrent conflict of interest exists if: (1) the representation of one client will be directly adverse to another client; or (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer. Notwithstanding the existence of a concurrent conflict of interest, a lawyer may represent a client if: (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and (4) each affected client gives informed consent, confirmed in writing.

- **What is a conflict check and when is it required?**

A conflict check is a process that ensures that the commitment of defense counsel (and his/her law firm) to the insured at any one time will not be distracted by his/her commitment to any other person. Conflict checks are usually performed during the establishment of the attorney-client relationship when defense counsel is retained to represent the insured. However, conflict checks are also performed when new parties are added to the litigation. The necessary elements of a conflict check are: (1) Establishing a thorough and well-maintained list of names – regardless of whether that is in a paper or electronic database; (2) Ensuring the process becomes a part of defense counsel's routine; and (3) Everyone at defense counsel's law firm is trained and involved. When one performs a conflict check, the following are checked: (1) The list of defense counsel's current and former clients; (2) The list of "other" parties to the specific lawsuit; and (3) The list of lawyers who are representing other parties in that specific lawsuit.

- **Waiver of the conflict of interest**

In general, a client's waiver of a conflict of interest is a contractual agreement between defense counsel and the insured whereby the insured consents to representation in spite of a known potential or actual conflict. For the waiver to be in effect, the consent must be "informed" and confirmed "in writing."

6. Excess Exposure Issues

- **Duty to investigate other potential coverage**

The New York Appellate Court determined in Shaya B. Pacific, LLC v. Wilson, Elser, Moskowitz, Edelman & Dicker, LLP (2006) 38 A.D.3d 34; 827 N.Y.S.2d 231, that there is no conflict between defense counsel and the insured regarding the investigation of other available insurance policies. The Appellate Court was unprepared to say as a matter of law that a failure to investigate the existence of excess insurance coverage may never give rise to a legal malpractice action. As a result, the Appellate Court essentially placed a new duty on defense lawyers to do whatever is necessary at the inception of the litigation to investigate other available insurance coverage and to prosecute tenders.

- **Defense counsel's liability to excess carriers**

When the excess carrier tries to pursue an equitable subrogation action by stepping into the shoes of the insured when pursuing a malpractice claim, defense counsel's obligations are not expanded and there may be liability. However, when the excess carrier claims it is an intended and foreseeable beneficiary of defense counsel's service, some courts have found that the duty of loyalty is actually to the benefit of the insured and, as a result, there is no liability.

HYPOTHETICALS

ETHICS FOR INSURANCE CARRIER SELECTED DEFENSE COUNSEL

HYPOTHETICAL ONE

FACT PATTERN:

An insurer ("Insurance Company") sought to appoint an attorney that worked "in-house" for the Insurance Company to defend the interests of its insureds for claims brought by third parties against its insureds pursuant to an insurance policy. To do so, Insurance Company proposes to establish a Law Division comprised of attorneys who will hold themselves out as a law firm practicing under the names of the attorneys of the firm. All attorneys of the Law Division will be salaried employees of the Insurance Company and all personnel matters (hiring, firing and compensation) will be handled by the Insurance Company. All correspondence and pleadings from the Law Division will use the firm's letterhead. However, the firm's letterhead will not inform the insureds that the attorneys are employees of the Insurance Company. The Insurance Company will have the right to assign individual cases to its Law Division or to outside counsel with the intention of assigning a percentage of these cases to the Law Division to save on costs. The Insurance Company will only assign the more complex cases to outside firms. All attorneys and other time keepers of the Law Division will bill their time to particular files. The Law Division will render statements to the Insurance Company with income credited to the Law Division with a corresponding expense charged to the Insurance Company on its books. In this manner, the Law Division seeks to operate as an independent law firm.

ETHICAL ISSUE:

May an insurance company retain its in-house counsel to represent an insured in litigation brought by third parties pursuant to the policy?

HYPOTHETICAL TWO

FACT PATTERN:

In a personal injury action brought by plaintiff against defendant AB Corporation wherein plaintiff alleged he developed leukemia as a result of his exposure to AB Corporation's benzene-containing products (the "Incident"), AB Corporation's insurer, California Insurance Company, hired defense counsel to defend its insured, AB Corporation, in this action. During its investigation, however, defense counsel learned certain facts that resulted in defense counsel believing that the Incident may not have been a covered event under the insurance policy issued by California Insurance Company through which AB Corporation tendered its defense to California Insurance Company.

ETHICAL ISSUE:

To whom does an attorney owe duties when he or she acts as insurance defense counsel and is hired by an insurer to represent an insured in the substantive defense of the insured's case? Specifically, to whom are the duties owed (a) where counsel discovers information that demonstrates the insured has or may have no coverage; or (b) where the attorney learns the insured has perpetrated a fraud for the purpose of obtaining coverage?

HYPOTHETICAL THREE

FACT PATTERN:

After soil and groundwater contamination in a city was traced back to a dry cleaning facility, the federal government brought an action against the owners of the property and its lessees to recover the costs of monitoring and remediating the contamination. These defendants subsequently filed third party actions against a supplier of dry cleaning products ("Supplier") seeking indemnity, contribution and declaratory relief. The Supplier tendered its defense of these third party actions to its insurers who accepted the tender subject to a reservation of rights, including the right to decline coverage for any damages resulting from an occurrence outside of the insurers' policies. The insurers subsequently retained defense counsel to provide the Supplier with a defense. The Supplier, however, refused to accept the retained defense counsel, arguing that the reservation of rights created a conflict of interest and demanded the insurers pay for counsel of its choosing.

ETHICAL ISSUE:

Was there a conflict of interest? Upon objection, are the insurers required to pay for counsel selected by the insured?

HYPOTHETICAL FOUR

FACT PATTERN:

Plaintiff sued his employer for damages, claiming a violation of various labor laws. The employer's primary insurance carrier hired a firm to represent plaintiff's employer in the action. In its retention letter, the carrier specifically warned the employer about the peril of excess exposure because the carrier's insurance policy only provided $1 million in coverage for the subject claim. The carrier admonished plaintiff's employer to search for potential excess coverage and to quickly notify any excess insurance carrier of the litigation. Three years into the subject litigation when the trial court awarded summary judgment to plaintiff, and on the eve of its subsequent damages trial, defense counsel tendered the defense of plaintiff's employer to a second insurance carrier with respect to the excess exposure issue. The second insurance carrier, however, disclaimed any such coverage on the basis that it had not received timely notice of the action and had no basis to conclude that plaintiff's employer was an insured under the relevant insurance policy. After a damages trial that resulted in a judgment in excess of $6 million, plaintiff's employer sued defense counsel, claiming it was negligent in failing to timely advise the second insurance carrier of the occurrence, which constituted a breach of contract.

ETHICAL ISSUE:

Does counsel defending an insured have a duty to investigate whether the insured has other potential insurance coverage available?