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Reservation about Reservations

I. Whether And When A Reservation of Rights or Denial Allows an Insured to Settle Without An Insurer's Consent

If an insurer declines to defend or defends pursuant to a reservation of rights, the insured may face personal, uninsured liability. In such cases, courts have responded to insureds' concerns by permitting them to avoid potential personal liability by transferring their risk back to their insurers. This transfer is often accomplished through settlements in which (1) the claimant and the insured consent or stipulate to a judgment (in practice, the amount of the judgment may exceed the insured's policy limit amount); (2) the parties execute a settlement agreement in which the plaintiff promises not to collect the judgment from the insured; (3) the insured assigns its claims or causes of action against its insurer to the plaintiff; and (4) the insured makes no payment to the plaintiff or makes only a minimal one. These agreements go by various names, usually following the names of the court decisions which produced them.

State law varies as to the circumstances under which a policyholder may enter into such an agreement and on what basis an insurer may object. Some key jurisdictions and the types of agreements allowed are discussed below.

A. Where An Insurer Has Denied Coverage

Many courts permit insureds to enter into these agreements where the insurer wrongfully declines to provide a defense to its insured, thereby breaching its duty to defend. States that have adopted this approach include: Arizona, Florida, California, Connecticut, Georgia, Illinois, Iowa, and New Jersey. *See e.g, Damron v. Sledge*, 105 Ariz. 151, 460 P.2d 997 (1969); *Coblentz v. American Surety Co. of New York*, 416 F.2d 1059 (5th Cir. 1969); *Hamilton v. Md. Cas. Co.*, 27 Cal.4th 718, 117 Cal.Rptr.2d 318, 41 P.3d 128, 134 (2002).

B. Where an Insurer Defends Subject To A Reservation of Rights

Notably, in some states courts allow an insured to enter into these agreements without the insurer's consent even where the insurer is defending under a reservation of rights. In these jurisdictions, if the insurer offers to defend the claim but also provides notice that it may decline coverage if the claim is successful, then the insured may opt to enter a stipulated judgment rather elect to go through with a trial. If the coverage dispute is later resolved in the insured's favor, the

stipulated judgment may then be enforced against the insurer, subject to a few defenses which we will discuss in detail below.

Arizona: The Arizona Supreme Court has held that in situations in which an insurer is defending under a reservation of rights, a policyholder does not breach its duty of cooperation when it enters into an independent settlement with a claimant that is only executable against the insurer. This is because, under Arizona law, an insurer and policyholder have "conflicting interests" when a defense is offered under a reservation of rights. *See U.S.A.A. v. Morris*, 741 P.2d 246 (Ariz. 1987). Because of its strong statement on allowing these types of agreements, *Morris* has become the seminal case on this issue.

Minnesota: The Minnesota Supreme Court recognized that a policyholder whose insurer has denied coverage under the policy may consent to a judgment against it and assign its rights against its insurer to the claimant/judgment creditor without being found to have breached its duty to cooperate with its insurer. In *Miller*, the insurer was defending the insured in the underlying action while the insured and insurer were simultaneously engaged in coverage litigation. The insured notified the insurer that it intended to settle with the claimant and enter into a stipulated judgment under which the claimant could only collect the judgment from the applicable insurance and could not collect any amounts from the insured. The court upheld the agreement, finding that the insured had not breached its duty to cooperate by accepting a settlement offer when the possibility of insurance coverage was in doubt. *Miller v. Shugart*, 316 N.W.2d 729 (Minn. 1982).

Maine: Like Minnesota, the Maine Supreme Judicial Court has held that when an insurer reserves the right to deny coverage, it loses the ability to control the litigation and an insured may settle without the insurer's consent. *Patrons Oxford Ins. Co. v. Harris*, 905 A.2d 819, 828 (Me. 2006).

Washington: Washington courts historically only allowed a stipulated judgment entered into by the insured without the insurer's consent where there was bad faith by the insurer. The Washington Supreme Court has recently held that, even in the absence of bad faith, when an insurer is defending under a reservation of rights and had an opportunity to be involved in a settlement between the insured and the claimant, and that settlement is determined to be reasonable, then it is appropriate to use the fact of the settlement to establish liability and the amount of the settlement as the presumptive damage award for purposes of coverage. *Mut. of Enumclaw Ins. Co. v. T&G Constr., Inc.*, 199 P.3d 376 (Wash. 2008). This decision has not been widely interpreted, and it is unclear whether the holding would apply in cases in which the insurer did not have the opportunity to be involved in the settlement discussions of the underlying case.

Wyoming: The United States District Court adopted the reasoning of Arizona courts and held that an insured may settle without the insurer's consent where the insurer is defending under a reservation of rights. Moreover, the insured's actions do not violate its duty to cooperate with the insurer. *Ins. Co. of N. Am. v. Spangler*, 881 F. Supp. 539, 543-44 (D. Wyo. 1995) (predicting Wyoming law).

B. Challenging Agreements Between The Insured And Claimant

A primary concern by insurers whose policyholders have entered into these stipulated judgments with the underlying plaintiff is the potential for large judgments. By nature of these agreements, the policyholder will eliminate any potential liability against it by obtaining an agreement by the underlying claimant not to execute against the policyholder. Therefore, the insured negotiating the amount of the stipulated judgment has very little, if any, incentive to negotiate a settlement amount that reflects the underlying claim's potential liability and liability defenses. However, courts have addressed this concern by holding that neither the fact nor amount of liability to the claimant is binding on the insurer unless the insured or claimant can show that the settlement was reasonable and prudent.

1. Insured Must Provide Insurer With Notice & Opportunity To Defend

An insurer is bound by the settlement made by its insured if, but only if, the indemnitor was given notice and opportunity to defend. By settling against the insurer's instructions, the insured, in effect, ousts the insurer from the defense of the action and assumes the defense himself.

2. The Requirement Of Reasonableness & The "Reasonably Prudent Person"

Regardless of the circumstances giving rise to a stipulated judgment, however, courts have required that the settlement pass a reasonableness test. "The test is whether the settlement was reasonable and prudent is what a reasonably prudent person in the insureds' position would have settled for on the merits of the claimant's case."

The "reasonably prudent person" referenced in this test means a person who has a stake in the outcome. It means a person who is making decisions as though the money that pays the settlement comes from his or her own pocket. For purposes of determining reasonableness a "reasonably prudent person" is defined as a person who (1) has the ability to pay a reasonable settlement amount from his or her own funds and (2) makes a settlement decision as though the settlement amount came from those personal funds. *See, e.g., Himes v. Safeway Ins*. Co., 66 P.3d 74, 85 (Ariz. Ct. App. 2003) (declining to consider the defendant's ability to pay).

> Washington: Washington law has a special mechanism requiring a reasonable determination in the underlying action prior to the entry of a stipulated judgment between a policyholder and a claimant. Courts conducting a "Chaussee analysis" (so named after the case giving rise to this test), will consider the following factors:
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> - the claimant's damages;
> - the merits of the policyholder's defense theory;
> - the relative fault of the claimant;
> - the risks and expenses of continued litigation;
> - the policyholder's ability to pay;
> - the extent of the investigation and preparation of the case;
> - any evidence of bad faith, collusion, or fraud; and
> - the interests of any other parties that were not released.

An insurer may intervene in these hearings to offer evidence and challenge the reasonableness of its policyholder's settlement with the underlying claimant before it is formally entered. The insurer does not have to make a separate showing that it has a valid interest that must be protected, which is sometimes required in other jurisdictions that permit intervention by insurers on a case-by-case basis.

3. Fraud Or Collusion

Insurers may also attack these agreements by showing that the agreement was the product of fraud or collusion. Courts will then analyze the circumstances surrounding these agreements to evaluate whether or not they were the result of fraud or collusion.

Arizona: The Arizona Supreme Court has stated that "in cases where the insurer has refused to defend and the parties enter into a *Damron* agreement, the insurer has no right to contest the stipulated damages on the basis of reasonableness, but rather may contest the settlement only for fraud or collusion." Parking Concepts, Inc. v. Tenney, 207 Ariz. 19, 83 P.3d 19, 22, n. 3. (Ariz. 2004).

Minnesota: "Collusion, for purposes of a *Miller-Shugart* settlement, is a lack of opposition between a plaintiff and an insured that otherwise would assure that the settlement is the result of hard bargaining." *Indep. Sch. Dist. No. 197 v. Accident & Cas. Ins. of Winterthur*, 525 N.W.2d 600, 607 (Minn. Ct. App. 1995) (finding that evidence of an insured's agreement to an excess judgment, willingness to pay the costs associated with the garnishment action, and agreement to provide an interest-free advance of half of the settlement amount, suggested possible collusion against the insurer).

4. An Insured's Duty To Cooperate

Most policies contain provisions requiring that the policyholder cooperate with the insurer and not enter into any settlements or make any commitment to pay without the prior agreement of the insurer. Many also contain anti-assignment provisions, which would also seem to be violated by these agreements. Nevertheless, insureds have argued that these provisions should not be enforced in cases where insurers have denied coverage (and in some jurisdictions, where insurers have merely reserved their rights to deny coverage), and the courts have generally accepted these arguments. Despite the fact that most insurance policies contain this language limiting a insured's ability to enter into agreements with the underlying claimant without the consent of the insurer, insurers have had little success defeating these agreements based on such language. Courts have continued to enforce these stipulated judgments between insured and the underlying claimants in the face of policy language expressly precluding such action. *See, e.g., Ins. Co. of N. Am. v. Spangler*, 881 F. Supp. 539, 543-44 (D. Wyo. 1995) (predicting Wyoming law).

C. Open Issues Regarding The Application Of *Morris*

As previously discussed, the Arizona Supreme Court's decision is *Morris* is the seminal case for allowing these agreements between an insured and the underlying claimant where the insurer is defending under a reservation of rights. However, courts addressing this issue in other jurisdictions have created variations on *Morris* which create unsettled issues.

Florida: At least one Florida court has found that an insured is entitled to enter into a settlement with the injured plaintiff without the insured's consent, where the insurer is defending subject to a reservation of rights. In that case, the insurer defended under a reservation of rights but violated a Florida statute which required that the insured must be informed of its right to have "mutually agreeable" counsel. The court noted that where an insurer wrongfully refuses to defend, the insured is entitled to make a reasonable settlement. The court held that what the insurer did was analogous to a wrongful refusal to defend. *Am. Empire Surplus Lines Ins. Co. v. Gold Coast Elevator, Inc*., 701 So.2d 904, 906 (Fla. 4th DCA 1997).

We note that this decision's rationale depends on the application of Florida's Claims Administration Statute, Fla. Stat. 627.426. Surplus lines carriers are not subject to the Claims Administration Statute, and thus it is questionable that the mutually-agreeable requirement would be imposed on surplus lines carriers. We are not aware of any cases dealing with this, but it would generally be best practice to give the insured a voice in the selection of counsel, and perhaps to notify the insured of its right to independent counsel in the reservation of rights letter.

Minnesota: One issue that remains unsettled in Minnesota is whether a Miller-Shugart settlement will be upheld where if the insurer has not denied coverage but has instead reserved its rights to deny coverage in the future. Because *Miller* (the case establishing these settlements) involved an insured defending under a reservation of rights, there is support for this position. *See Bob Useldinger & Sons, Inc. v. Hangsleben,* 505 N.W.2d 323 (Minn. 1993); *McNicholes v. Subotnik*, 12 F.3d 105 (8th Cir. 1993). At least one Minnesota court has found that a policyholder may enter into a Miller-Shugart settlement only when the insurer has completely denied coverage. *See Buysse v. Baumann-Furrie & Co*., 481 N.W.2d 27, 29 (Minn. 1992).

D. Is *Morris* The Wave of the Future? Pennsylvania's Recent Adoption Of *Morris*

The Pennsylvania Supreme Court recently adopted a limited version of the Arizona Supreme Court's decision in *Morris* and this case may reveal a trend towards these types of decisions. In *Babcock & Wilcox v. Am. Nuclear Insurers*, 2013 Pa. Super 174 (Pa. 2015), in an issue of first impression, the Pennsylvania Supreme Court has held that an insured does not forfeit coverage by entering into a fair, reasonable, and non-collusive settlement without an insurer's consent where the insurer is defending under a reservation of rights and the insurer has declined to settle.

In *Babcock*, the insureds were sued in a class action over alleged bodily injury and property damage caused by emissions from nuclear facilities. The insurer defended under a reservation of rights, asserting that the claims were not coverage because of the nuclear energy hazard, damages in excess of the policy limits, and claims for injunctive relief and punitive damages. An initial verdict against the insured was entered in the amount of $36 million, but a retrial was granted. Because the insurer felt it could successfully defend the case, it refused settlement offers. The insured then settled with the claimants for $80 million.

The insurers urged the Pennsylvania court to adopt the Arizona Supreme Court's decision in *Morris*. However, the court opted to adopt a modified *Morris* standard, holding that "where an insured accepts a settlement offer after an insurer breaches its duty by refusing the fair and reasonable settlement while maintaining its reservation of rights, and thus, subjects an insured to potential responsibility for the judgment in a case where the policy is ultimately deemed to cover the relevant claims." Moreover, the court required that the settlement must be "fair and reasonable from the perspective of a reasonably prudent person in the same position of [the insureds] and in light of the totality of the circumstances."

The *Babcock* decision follows logically from the Minnesota court's decision in *Miller*, where an insurer also could have settled and choose not to do so given the pendency of coverage litigation and the court found that the insured could settle directly with the insurer.

The importance of *Babcock* and the danger it creates is that where an insurer has a settlement offer put before it and it refuses a settlement offer that is reasonable from the perspective of the insured, it may open the insurer up to allowing the insured to enter into an unauthorized settlement directly with the claimant.

E. Strategies For Addressing These Risks In *Morris* States

1. Seeking Declaratory Relief

Where an insurer has a strong coverage defense, the insurer may wish to initiate an early declaratory judgment action to obtain a quick determination of coverage while the underlying action is ongoing. However, many jurisdictions (Texas, for example) will not allow a simultaneous declaratory judgment action if the issues overlap with those in the underlying action. In cases where an insurer's coverage defenses are not central to the liability in the underlying action, an insurer may be able to determine whether coverage exists before a policyholder settles with the claimant.

If the declaratory judgment action is successful and results in a determination of no coverage, the insurer's obligations will cease. If the action results in a finding of coverage, an insurer may accept coverage and prevent the policyholder from entering into collusive agreements with the claimant; thus, permitting the insurer to maintain control over the underlying litigation. The coverage action may also dissuade claimants' counsel from releasing the insured from liability where the insurer has a strong coverage defense.

2. Contesting Reasonableness

Certain jurisdictions require an insurer to intervene in the underlying action to object to the reasonableness of a stipulated judgment. A claims professional should know whether the jurisdiction at issue permits (or requires) intervention into the underlying action, and should retain coverage counsel who can pursue intervention as soon as the insurer is aware of a potentially collusive stipulated judgment.

3. Reserve Rights Only When Absolutely Necessary

The final point is an obvious one. Carriers must seriously assess the consequences of reserving rights in light of these case law developments. In the affected states, only when a reservation of rights is both necessary and substantive should an insurer issue one.

II. Whether And When A Reservation Of Rights Triggers An Insured's Right To Independent Counsel

A. Unresolved Issue In Some States

In a few states, the issue of whether and, if so, when the insured would have a right to independent counsel paid for by the insured has yet to be addressed and resolved by way of either published state court decision or state statute. In such a state, there is usually only one or more non-published state court decisions or federal court decisions predicting what the state high court would hold. Examples:

Arkansas: There is currently no published state court decision or statute, but some federal district courts have concluded that the state courts would hold that a reservation resulting in a conflict of interest would trigger a right to independent counsel. See, e.g., *Northland Ins. Co. v. Heck's Service Co., Inc.* (E.D.Ark. 1985) 620 F.Supp. 107; and *Union Ins. Co. v. Knife Co.* (W.D. Ark. 1995) 902 F. Supp. 877.

Colorado: There is currently no published state court decision or statute. The federal district courts have predicted that Colorado would adopt the approach that, in a conflict of interest situation, appointed defense counsel only has one client - the insured – and is required by state professional ethics rules to not consider the insurer's interests in handling the insured's defense. See, e.g., *Essex Insurance Company v. Tyler* (D.Colo.2004) 309 F.Supp.2d 1270.

B. Where The Issue Has Been Resolved By The State Courts, Typically, One Of Three Approaches Has Been Adopted

The majority of states have adopted, almost always by way of case law rather than statute, one of the following three basic approaches regarding the right to independent counsel issue.

1. "No Right To Independent Counsel" Approach

In some states, the insurer can provide a defense by way of appointed defense counsel even where the insurer reserves its rights and this reservation results in a conflict of interest between insurer and insured. A reservation of rights never triggers a right to independent counsel.

The typical rationale for a state's adoption of this "no right to independent counsel" approach is: There is no "tripartite" relationship between insurer, insured and defense counsel retained by the insurer to defend the insured against third-party claims. Defense counsel appointed by the insurer has only one client – the insured – and does not also represent the interests of the insurer. It is the

ethical duty of appointed defense counsel to not consider the interests of the insurer when handling the insured's defense. Counsel must only consider the interests of counsel's singular client – the insured. The states adopting this approach include:

> Alabama: When rights are reserved, both the insurer and appointed defense counsel owe the insured an "enhanced obligation of good faith" which protects the insured's interests. The insurer satisfies its enhanced duty by (1) conducting a thorough investigation, (2) retaining competent defense counsel, who, along with the insurer, "must understand that only the insured is the client," (3) informing the insured of the defense and "all developments relevant to his policy coverage and the progress of the lawsuit," and (4) "refrain[ing] from engaging in any action which would demonstrate a greater concern for the insurer's monetary interest than for the insured's financial risk." See, e.g., *State Farm & Cas. Co. v. Myrick* (M.D.Ala. 2009) 611 F. Supp. 2d 1287.
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> Tennessee: The Tennessee Rules of Professional Conduct that govern defense counsel's conduct are viewed as sufficient to safeguard the insured, and the insurer is viewed as having no right to control the methods or means by which the attorney defend the insured. Insurer-retained defense counsel does not owe a duty of loyalty to the insurer. *Tyson v. Equity Title & Escrow of Memphis LLC* (W.D. Tenn. 2003) 282 F. Supp. 2d 829, and *Givens v. Mullikin ex rel. Estate of McElwaney* (Tenn. 2002) 75 S.W.3d 383.

2. "Any Reservation" Triggers A Right To Independent Counsel

In some states, any reservation of rights triggers a right to independent counsel. The insured has a right to independent counsel whenever the defending insurer asserts, for whatever reason, that not all claims alleged in the suit are covered under the policy. The primary basis for adoption of this approach (as well as for the "only an actual conflict" triggers a right to independent counsel approach discussed below) is the particular state's recognition of a "tripartite" relationship between the insurer, the insured, and insurer-appointed defense counsel.

The "tripartite" relationship is the relationship between defense counsel, the insurer, and the insured that is created when counsel is hired by the insurer to defend a suit against the insured. Defense counsel has two clients, the insurer that hired counsel and the insured that counsel is obligated to defend, and the primary, overlapping, and common interest of defense counsel and counsel's two clients is the speedy and successful resolution of the suit against the insured. However, when the insurer reserves its rights on a coverage issue, defense counsel may be facing the ethical dilemma of two clients with opposing interests. The classic ethical dilemma situation is where the underlying complaint alleges mutually exclusive theories of recovery, one covered and one not, such as, in the case of standard "occurrence" (accident)-based Bodily Injury and Property Damage Liability Coverage, negligence (covered) and intentional tort (not covered). If the insurer reserves rights pursuant to the "occurrence" definition, the potential exists for appointed defense counsel to, through the way the defense is handled, steer the case towards a result that is either favorable on the coverage issue to the insurer or to the insured. In this situation, the reservation of rights results in an actual conflict of interest between insurer and insured.

However, in an "any reservation" triggers a right to independent counsel jurisdiction, it does not matter whether there is any reservation of rights that in fact results in an "actual conflict" of interest. If the insured reserves any right, regardless of whether or not this reservation results in any conflict of interest (potential or actual), the insured has a right to independent counsel.

The states that have adopted the "any reservation" triggers a right to independent counsel approach include:

Maine: Where the insurer choses to defend the insured under a reservation of rights, it gives up the ability to control the insured's defense. If an insurer could control the case under a reservation of rights, it could insist on full litigation and would thereby expose the insured to the risk of personal liability and then seek to deny coverage if the verdict is unfavorable to the insured. By allowing the insured to control his own case when the insurer issues a reservation of rights, the insured can protect himself "from the sharp thrust of personal liability," and the insurer still has a meaningful opportunity to protect its own interests in a declaratory judgment action where it may assert coverage defense. *Patrons Oxford Ins. Co. v. Harris* (Me. 2006) 905 A.2d 819.

Massachusetts: A reservation of rights creates a per se conflict of interest that triggers a right to independent counsels. The insurer cannot reserve its rights to disclaim coverage and at the same time control the insured's defense. 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 to either relinquish its reservation of rights or relinquish its defense of the insured and reimburse the insured for its defense costs. See, e.g., *Sullivan, Inc. v. Utica Mut. Ins. Co.* (Mass. 2003) 788 N.E.2d 533.

3. Only A Reservation That Results In An "Actual Conflict" of Interest Triggers A Right To Independent Counsel (Majority Approach)

In the majority of states that have addressed the right to independent counsel issue, either by case law or statute, the insurer must offer independent counsel paid for by the insurer only where the insurer has reserved one or more rights that result in an "actual conflict" of interest between the insurer and insured. States that have clearly adopted the "actual conflict" approach include: Alaska, California, Illinois, Kansas, Louisiana, Maryland, Minnesota, Missouri, Nevada, New Hampshire, New York, North Dakota, Ohio, Oklahoma, Oklahoma, Pennsylvania, Rhode Island, and Texas.

Here are two examples of states applying the "actual conflict" of interest approach:

California: A reservation of rights per se does not result in an actual conflict triggering the right to independent counsel. 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. To trigger a right to independent counsel, the reservation must result in a conflict of interest that is "significant, not merely theoretical" and "actual, not merely potential." For the insured to have a right to independent counsel, it must be shown how

appointed defense counsel could control the outcome of the particular coverage issue which is the subject of the reservation. Whether a conflict of interest is significant and actual is a question of fact. See, e.g., Cal. Civ.Code §2860(b); *San Diego Federal Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358; and *Federal Ins. Co. v. MBL, Inc.* (2013) 219 Cal.App.4th 29.

New York: Where the insurer is liable for only some, but not all, of the claims at issue, and the insurer reserves its rights, the insurer's interest in defending the suit is in actual conflict with the insured's interest. A conflict of interest requiring retention of separate counsel does not arise in every case where multiple claims are made. Independent counsel is only necessary 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 the attorney defeat liability only upon grounds which would render the insurer liable. *Prashker v. U.S. Guar. Co.* (1956) 136 N.E.2d 871; *Public Service Mut. Ins. Co. v. Goldfarb* (1981) 425 N.E.2d 810; and *Landon v. Austin* (N.Y.App. Div. 2015) 11 N.Y.S.3d 721.

C. State Statutes Addressing The Right To Independent Counsel

As to those states that have expressly addressed the right to independent counsel issue, almost all of these states address the issue by way of case law, rather than by statute.

Only two states currently have right to independent counsel statutes - California and Alaska. See California Civil Code §2860 (enacted 1987; amended 1988) and Alaska Stat. 21.96.100 (enacted 1995; amended 1997). In addition, Guam has adopted a right to independent counsel statute [22 G.C.A. § 12111] which appears to be a duplicate of California Civil Code §2860.

The California and Alaska statutes are very similar. Each statute describes when a conflict of interest triggering the insured's right to select independent counsel arises. Pursuant to the California statute, there is such a conflict when the "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." Pursuant to the Alaska statute, there is such a conflict when the "insurer reserves the insurer's rights on an issue for which coverage is denied." Both statutes expressly state that there is no conflict triggering a right to independent counsel as to a claim of punitive damages, a claim of damages in excess of policy limits, or claims or facts for which the insurer denies coverage.

Both statutes (1) provide that, when there is a conflict, the insurer must provide independent counsel unless the insured executes a written waiver of the right, (2) specify the terms of the required written waiver, (3) state that the insurer may insist that independent counsel have litigation experience as described in the statute and maintain malpractice insurance, (4) require that independent counsel and the insured consult with the insurer on all matters relating to the civil action and timely disclose to the insurer all information relevant to the civil action, except information that is privileged and relevant to disputed coverage, and (5) state that both counsel representing the insurer and the insured's independent counsel must be allowed to participate in

all aspects of the civil action and must cooperate fully in exchanging information that is consistent with ethical and legal obligations owed to the insured.

Both statutes include a limited attorney fee rates provision providing that, unless the policy says otherwise, the insurer is only obligated to pay independent counsel at 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. However, the Alaska statute has an additional provision regarding payment of independent counsel that is not included in the California statute, The provision states that the insurer (1) is not obligated to pay fees and costs to defend "an allegation for which coverage is properly denied," (2) is only responsible to pay fees and costs to defend "allegations for which the insurer either reserves its position as to coverage or accepts coverage," and (3) independent counsel must keep detailed records allocating fees and costs.

The Alaska statute also has an additional provision regarding settlement by the insurer. The provision states that, when an insured is represented by independent counsel, the insurer may settle directly with the plaintiff if the settlement includes all claims based upon the allegations for which the insurer previously reserved its position as to coverage or accepted coverage, regardless of whether the settlement extinguishes all claims against the insured.

Illinois does not currently have a right to independent counsel statute. However, Illinois Senate Bill 1296, which would create an "Insured's Independent Counsel Act," was introduced in 2015 and is under consideration by the state legislature. The proposed Act would: (1) limit the requirement of providing independent counsel to situations where the reservation of rights results in a "significant and actual conflict of interest," (2) specify certain situations where there is no such conflict, and (3) include provisions regarding independent counsel's selection, retention, and duties, privileged information, waiver of the right to independent counsel, and cooperation between the insurer, insured, and independent counsel.

Florida does not have a right to independent counsel statute. However, it does have a statute requiring that the insurer retain "independent counsel which is mutually agreeable to the parties." Fla. Stat. §627.426. To be "mutually agreeable," the insured must actually approve, not merely fail to object to, the selected counsel. See, e.g., *Am. Empire Surplus Lines Ins. Co. v. Gold Coast Elevator, Inc.* (Fla.App. 1997) 701 So. 2d 904.

D. What Is An "Actual Conflict" Of Interest?

A court adopting the "actual conflict" of interest approach regarding the right to independent counsel looks to the fact of the particular case to decide whether a particular reservation of rights in fact results in an "actual conflict." The question to answer is generally: Does this reservation result in a situation where appointed defense counsel could (would be in a position to) control the outcome of the coverage issue by the way he or she handles the insured's defense (e.g., through discovery, jury instructions and special verdicts)?

Here are some examples of reservations that a court applying the "actual conflict" approach is likely to conclude <u>do not</u> result in an "actual conflict" triggering a right to independent counsel:

- No coverage for punitive damages (*Note*: Appointed defense counsel would not be in a position, by virtue of the punitive damages claim, to reduce the insurer's potential liability at the expense of the insured.);

- No coverage for damages in excess of policy limits (*Note*: When plaintiff seeks damages in excess of the policy limits, there may be a conflict of interest between the insurer and the insured regarding whether and for what amount the lawsuit should be settled. However, that conflict does not affect how the case should be defended.);

- A reservation concerning a type of injury or damage only partially covered by the policy pursuant to application of policy exclusion or other coverage limitation stated in the policy;

- A reservation regarding a coverage dispute which has nothing to do with the facts being litigated in the underlying action against the insured (e.g., a reservation regarding application of a "resident relative" exclusion, an issue turning solely on interpretation of policy language, the issue of whether the insured misrepresented who would be driving covered autos, or the insured's failure to comply with the policy conditions, such as cooperating with the insurer or giving the insurer timely notice of a claim); and

- A reservation whereby the insurer denies coverage for a particular cause of action outright (e.g. cause of action for inverse condemnation precluded from coverage by an inverse condemnation exclusion that applies regardless of whether the insured acted negligently or intentionally).

Here are some examples of reservations that a court applying the "actual conflict" approach is likely to conclude do result in an "actual conflict" triggering a right to independent counsel.

- A reservation based on the nature of the insured's conduct resulting in the alleged injury or damage and that conduct is subject to litigation in the underlying action against the insured (e.g., a reservation based on lack of an occurrence [accident] or application of an exclusion for intentional acts or injury or damage expected or intended from the standpoint of the insured);

- Where facts directly affecting the coverage dispute which is the subject of the reservation will clearly be determined in the underlying action (e.g., coverage dispute over whether the insured's negligence was active or passive); and

- Where the amount of available insurance would be affected by appointed defense counsel's handling of the underlying action against the insured (e.g. rights were reserved pursuant to policy deductibles, and decisions on class certifications made in the underlying action would affect the number of deductibles).

E. To Reserve Or Not Reserve

Issuance of a reservation of rights can be a "two edged sword." The insurer wants to protect its rights against waiver and estoppel arguments. However, reserving rights will alert the insured and the insured's counsel to specific coverage issues such that the information they disclose to the insurer can be tailored and edited to protect the insured's interests.

In addition, where applicable state law recognizes the right to independent counsel and the particular reservation of rights would trigger that right, reserving rights means that the insurer will lose control over the defense and faces a potential less effective reporting by independent counsel situation.

Reserving rights may also give the insured the right to unilaterally settle. In some states, such as California, the insurer retains the exclusive right to settle so long as the insurer defends the insurer, even if that defense is subject to rights. However, as discussed above, in a growing number of states, where the insurer offers to provide a defense subject to reservation of rights, this offer results in the insured having the right to unilaterally settle with, and assign rights against the insurer to, the plaintiff. The general rule is that the insurer is liable for this settlement so long as it was fair and reasonable and insurance coverage is afforded under the insurer's policy for the underlying situation.

Because of these factors, the insurer should perform a cost/benefit analysis regarding a particular reservation of rights, considering: How important is the reservation? Would it make a difference? What are the chances of prevailing on this coverage defense? Is the reservation worth the insurer's loss of control of the defense and the risk of less effective reporting by independent counsel? Would reserving rights give the insured the right to unilaterally settle?