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"Mix It Up: Counsel's Ethicial Obligations and Fair Claims Handling"

I. The Insurance Defense Challenge

The tripartite relationship, or the insurance triangle as it is sometimes called, represents a truly unique version of the attorney-client relationship. One attorney, two clients. In order for the tripartite relationship to succeed, collaboration and communication between attorney, insurer, and insured is critical. The nature of the claim presented, as well as the coverage afforded, can present a difficult, even "awkward," environment for counsel, claims handler, and insured. The two examples below highlight a variety of ethical and claims handling challenges presented by the tripartite relationship. In reviewing these case studies, we consider counsel's obligations to both the insurer and insured, the implications of a demand for independent counsel, and fair claims handling practices in order to explore outside the box strategies to ensure successful outcomes within the insurance triangle.

A. Review of Ethical Obligations and Claims Handling Standards

An attorney hired by an insurance company to defend an action against one of its insureds owes duties to both the insurance company and the insured under tort law and under the ABA Rules of Professional Conduct. In the absence of a conflict of interest between the insurer and the insured which would preclude an attorney from representing both, the attorney has a dual attorney-client relationship with the insurer and the insured. (*State Farm Mut. Auto. Ins. Co. v. Federal Ins. Co.* (1999) 72 Cal.App.4th 1422, 1429.)

Several ABA Model Rules of Professional Conduct are relevant to the tripartite relationship:

1. Rule 1.2: Scope of Representation.

An attorney must abide by a client's decision whether to settle a matter.

2. Rule 1.4: Communications.

An attorney must respond to a client's request for information. An attorney is required to solicit client input about the status and progress of the case.

3. Rule 1.6: Confidentiality of Information.

An attorney must maintain client confidentiality.

4. Rule 1.7: Conflict of Interest.

An attorney shall not represent a client if the representation will create a conflict of interest. The attorney may, however, avoid potential conflicts of interest by delineating the scope of his representation early in the litigation. This is permitted under Rule 1.2(c), which provides that a lawyer may limit the scope of his representation if the client consents after consultation.

5. Rule 5.4: Professional Independence of a Lawyer.

An attorney must exercise his professional judgment on behalf of the client.

B. Scenario 1 – Commercial General Liability Study

A standard commercial general liability policy is issued to an insured in the business of owning and operating mobile home parks. The policy's insuring agreement affords coverage for "bodily injury" or "property damage" caused by an occurrence. An occurrence is defined as an "accident." 25 individual residents file a complaint alleging causes of action for (1) nuisance, (2) breach of contract, (3) intentional interference with property rights, (4) Breach of Mobilehome Residency Laws, (5) violation of unfair business practice statutes, (6) breach of warranty of habitability, (7) breach of covenant of quiet enjoyment, (8) declaratory and injunctive relief. In sum, the allegations assert the owners have failed to keep up the mobilehome park. They alleged the owners have failed to provide and maintain facilities, and, specifically the park's common areas. The plaintiffs complain of slow flushing toilets, bad tasting water, inadequate notice of water service shut-offs, low water pressure, improper overcharges for water service, insufficient electrical system capacity making it difficult to run multiple appliances simultaneously, overcharges for electricity, cracked asphalt associated with poor drainage, substandard pool facilities, broken playground equipment, as well as unspecified damage to personal property caused by sewage back-ups and inadequate drainage.

Plaintiffs seek injunctive relief ordering the owners to make necessary repairs, an injunction prohibiting the park's unfair business practices, costs associated to repair/replace damaged personal property, disgorgement of improper profits, statutory penalties as permitted under the Mobilehome Residency Law, punitive damages associated with the owners' willful disregard of the residents' well-being, and attorneys' fees as permitted by statute.

The applicable CGL insurance policy includes standard exclusions for "expected/intended" conduct, pollution, and statutory penalties.

The defense of the lawsuit is tendered to CGL carrier who acknowledges a defense obligation and issues a comprehensive reservation of rights disclaiming coverage for much of the claim. The carrier also reserves its rights to seek reimbursement of defense costs associated with clearly uncovered claims. The park owners demand independent counsel based on the reservation of rights. That demand is denied. The matter is subsequently assigned to insurance defense counsel.

C. Scenario 2 – Unique Professional Liability Issues

A professional liability insurer provides Errors & Omissions claims made coverage to an inspection company. The insured company has a long track record of providing pipe inspection services for refineries throughout the country. It recently developed a new unit that specializes in the inspection of gas line welds. The company just received a written notice of claim from a local utility company regarding the insured's weld inspection protocol. According the utility, industry standard requires multiples x-rays to assess the integrity of the weld. According to the claim document, the insured's employee responsible for the lion's share of the inspections only took a single x-ray. When asked why, the employee reported it was "just quicker that way." The utility is now to expect significant regulatory fines. The notice of claim encloses a draft complaint that contains causes of action for breach of contract, negligence and contractual indemnity. During its initial investigation, the errors & omissions insurer learns there may have been some discussion regarding this claim prior to the inception of its policy. The insurance application did not, however, include any such reference. It is undisputed the first written notice of the claim was received during the policy period. Given the potential magnitude of the claim, the professional liability carrier assigns defense counsel during the claims stage and issues a reservation of rights based on the intentional act and contractual liability exclusions contained in its policy. It continues to investigate a possible policy rescission action based on a material misrepresentation in the insurance application. Defense costs erode the professional liability policy limits.

The inspection company also maintains CGL coverage. That carrier assigns defense counsel but maintains from the outset that it has no obligation to indemnify the insured based on the fact no suit has been filed, the absence of "property damage" as well as its professional services exclusion.

The two scenarios outlined above highlight the challenges facing the insurer-retained counsel assigned to defend them.

II. Defending the Claim

Generally speaking, any potential for coverage under an insurance policy triggers an immediate duty to defend. Moreover, the only defense is a complete defense,

regardless of coverage limitations. Where some claims are potentially covered and others are not, the insurer must provide a defense of the entire action, including those claims for which there is no potential coverage under the policy. (See e.g. *Buss v. Sup. Ct. (Transamerica Ins. Co.)* (1997) 16 Cal.4th 35, 48.) It is enough that a single claim is potentially covered by the policy. (*Id.* at 49.)

A. Reservation of Rights and Demands for Independent Counsel

The insurer must provide a full defense by competent counsel as part of its duty to defend. This duty may be breached where an insurer provides defense counsel whose ability to represent the insured is affected by a conflict of interest. Various circumstances may create a conflict of interest for defense counsel under applicable statutes and rules of professional conduct, including the following:

- The insurer provides a defense subject to a reservation of rights and the outcome of the coverage dispute can be affected by the manner in which the case is defended (Civ. C. § 2860(b));
- The insurer has commenced litigation against the insured, whether or not related to the lawsuit it is obligated to defend (see *Truck Ins. Exch. v. Fireman's Fund Ins. Co.* (1992) 6 Cal.App.4th 1050, 1059);
- The insurer seeks to settle a third party claim for an amount exceeding its policy limits, exposing the insureds to excess liability, and the insureds refuse to consent thereto (*Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal.App.4th 1372, 1396); and
- Any other situation in which the interests of the insurer and the insured are materially different or in which the insurer seeks to provide less than a full defense (see *Spindle v. Chubb/Pacific Indem. Group* (1979) 89 Cal.App.3d 706, 713).

Defense counsel faced with such conflicts must make written disclosure and obtain informed written consent from the insured before accepting or continuing the representation. (See CRPC 3-310.)

The fact an insurer defends under a reservation of its right to deny coverage does not, by itself, create a conflict entitling the insured to select Cumis counsel. (*Gafcon, Inc. v. Ponsor & Assocs*. (2002) 98 Cal.App.4th 1388, 1421.) In determining whether a conflict exists, the court must analyze "the parties' respective interests to determine if they can be reconciled or if there is a conflict of interest which puts appointed counsel in the position of having to choose which master to serve." (*Federal Ins. Co. v. MBL, Inc.* (2013) 219 Cal.App.4th 29, 42.) The insurer must provide independent counsel for the insured when resolution of some issue in the lawsuit between the third party and the insured will bear directly on the outcome of the coverage dispute between the insurer and the insured. (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc*. (1984) 162 Cal.App.3d 358, 364.)

B. Insurance Counsel's Duties and Reporting Obligations

Defense counsel employed by the insurer to represent the insured owes the insured the same obligation of good faith and fidelity as if he had retained the attorney personally. (*Bogard v. Employers Cas. Co.* (1985) 164 Cal.App.3d 602, 609.) "Defense counsel's primary duty is to further the best interests of the insured." (*Purdy v. Pacific Auto Ins. Co.* (1984) 157 Cal.App.3d 59, 76.)

C. Collaborative Resolution Strategies

Defense counsel's duty includes the obligation to advise the insured about the potential consequences of an adverse verdict and to attempt settlement when appropriate. Rule 1.2 of the Rules of Professional Conduct makes clear an attorney must abide by a client's decision whether to settle or not. Defense counsel must provide the insurer *and the insured* all facts necessary to make an informed decision regarding settlement. (*Novak v. Low, Ball & Lynch* (1999) 77 Cal.App.4th 278, 285.) When the insurer decides to settle a claim against the insured, defense counsel should disclose this fact to the insured, remind the insured of the insurer's right to control settlement and defense, and state defense counsel's intent to follow the insurer's settlement instructions. (See ABA Form. Opn. 96-403.)

D. Concurrent Coverage

The duty to defend and/or indemnify may arise when two or more insurance policies cover the same risk, including the following:

- Insurers covering the same risk at the same time ("double insurance") (*Martin Marietta Corp. v. Insurance Co. of No. America* (1995) Cal.App.4th 1113, 1135);
- Insurers covering the same risk in different years when a loss "triggers" coverage in each of those years ("successive insurers") (*Montrose Chem. Corp. of Calif. V. Admiral Ins. Co.* (1995) 10 Cal.4th 645, 689);
- Insurers covering the same risk at the same time at different levels (i.e. primary vs. excess (umbrella) insurance) (*Olympic Ins. Co. v. Employers Surplus Lines Ins. Co.* (1981) 126 Cal.App.3d 593, 597-598); and
- Reinsurers who have agreed to insure all or a portion of the risk initially underwritten by another insurer (*Ascherman v. General Reinsurance Corp.* (1986) 183 Cal.App.3d 307, 312).

Where several layers of liability insurance coverage are available, issues may arise as to the respective insurers' rights and obligations as to third party claims against the insured. It is critical for defense counsel to work with the insurance carriers to ensure a full defense is provided to the insured. At times, the availability of concurrent coverage requires creative strategies to resolve conflicting defense and indemnity obligations.