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Dancing in a Minefield: Avoiding Ethical Pitfalls

A comprehensive General Liability Insurance policy requires insurer to both indemnify and provide defense, even against "false, fraudulent or groundless" suits and claims. This relationship between appointed counsel, insurer and policyholder is a minefield of potential ethical pitfalls because while defense counsel owes loyalty and fiduciary duties to the policyholder, defense counsel also has a strong financial interest to the insurer. (*See Grasso v. Mid-Century Insurance Co.* (Ill. App. 1989) 536 N.E.2d 977, 981.) Ethical issues arise largely under four main categories: initial required disclosures to any insured client, potential conflicts with litigation guidelines, role of independent counsel, and responses to excess policy demands.

I. Initial Required Disclosures to Any Insured Client

Duty to inform policyholder of available coverage

Some courts have held an insurer has a duty to inform its policyholder of all available insurance coverage. In Montana, an insurer has an affirmative duty to inquire as to existence of other applicable insurance so that the insured may make an informed decision regarding the tender of defense to multiple insurers. (*Casualty Indemnity Exchange Insurance Co. v. Liberty National Fire Insurance Co.* (D. Mont. 1995) 902 F. Supp. 1235.) Where insurer does not satisfy the obligation to determine the existence of other insurance – placing the insured at risk because they cannot make a deliberate and informed decisions regarding tendering of defense – the insurer may not seek equitable contribution. (*Id.*) This duty rule applies both when insurer seeks contribution from a coinsurer as well as from a policyholder. *(See American Star Insurance Co. v. Allstate Insurance Co.* (Ore. App. 1973) 508 P.2d 244.)

Duty to disclose conflicts of interest

Defense counsel owes fiduciary duties to the policyholder which requires counsel to fully disclose all potential conflicts of interest and all information relevant to the policyholder's defense, as well as settlement offers. (*See Tank v. State Farm Fire & Casualty Co*. (Wash. 1986) 715 P.2d 1133.)

II. Potential Conflicts with Litigation Guidelines

Risk of violating the standard of care

Litigation guidelines are often imposed by the insurer on both in-house and outside attorneys that restrict work that can be performed and costs that can be incurred by counsel that ostensibly is to represent the policyholder. Defense counsel is required to provide the insured client with competent representation regardless of billing guidelines imposed on them by insurers. Under Model Rule 1.1 a lawyer must provide competent representation to a client. Additionally, the defense attorney's primary duty of loyalty is to the policyholder. (*See* Model Rules of Professional Conduct Rule 1.7 (Comment).) The guidelines risk violating the standard of care because is often non-attorney claims handlers granting or denying approval before lawyers can complete certain tasks.

Not only does this put the defense counsel at risk of breaching the duty of care, but it also puts insurance companies at risk of civil liability. Should a defense attorney breach the professional standard of care insurance companies may put themselves at risk for suits alleging a breach of the duty to defend, vicarious liability for the defense attorney's negligence, and bad faith claims. Some courts hold insurers vicariously liable for a defense attorney's negligent representation of a policyholder on the rationale that the outside attorney was an agent of the insurance company. (Seventh Circuit: *Outboard Marine Corp. v. Liberty Mutual Insurance Co.* (7th Cir. 1976) 536 F.2d 730; *See also Delmonte v. State Farm Fire & Casualty Co.* (Haw. 1999) 975 P.2d 1159 (holding insurance companies that require defense attorneys to observe billing guidelines may also be found liable for breaching their duty to defend the policyholder and acting in bad faith).)

Freedom of contract allows insurers to use litigation guidelines to define the financial relationship between an insurance carrier and its defense counsel. (Legal Ethics Comm. of the Indiana State Bar Association, Op. 3 of 1998.) The provisions can present ethical challenges when the negotiated financial terms materially desensitize defense counsel to perform tasks which are reasonable and necessary to the defense of the insured. (*Id.*) The ethical impermissibility can become more distinct when billing guidelines conflict with local rules of practice and the Federal Rules of Civil Procedure. (*Frederick v. UNUM Life Insurance Co.* (D. Mont. 1998) 180 F.R.D. 384, 385.)

Counsel is required to provide clients with competent representation regardless of the billing guidelines imposed on them by insurers

Litigation guidelines risk running up against Model Rules 2.1 and 5.4(c). Model Rule 2.1 states that "In representing a client, a lawyer shall exercise independent professional judgment and render candid advice." Model Rule 5.4(c) provides "A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services." Defense counsel's professional judgement might be overly confined when guidelines restrict discovery, limit pleadings, and require attorney to obtain the insurer's approval before conducting legal research.

Defense counsel must inform the policyholder of the restriction on defense counsel's professional judgment when the guidelines prevent defense counsel from acting in the best interest of the policyholder. The Professional Responsibility Committee of the Vermont Bar

Association ruled that a defense attorney must receive the informed consent of a policyholder before implementing the insurers litigation guidelines (Vermont Bar Ass'n Professional Responsibility Committee, Advisory Op. 98-7 (1998); see also, Mallen, "Looking to the Millennium: Will the Tripartite Relationship Survive?" 66 Def. Couns. J. 481, 487 (Oct. 1999).) Additionally, defense counsel *must* withdraw if they believe the billing guidelines will materially affect the defense of the policyholder. (*See* Rules of Professional Conduct Committee of the Washington State Bar Ass'n, Formal Op. 195 (1999).)

III. Role of Independent Counsel

When might a conflict arise?

Conflicts often arise when the complaint alleges claims outside the scope of the coverage, and even when complainant alleges only covered claims and seeks damages within policy limits. For example, defense counsel might discover facts that claimant's injuries resulted from type of injury not covered under the policy, the policyholder sued on numerous theories – only one of which is covered by the policy, or a third party's claim is not covered under the liability policy. The duty to defend will require defense even, if ultimately, no coverage exists. Because the insurer's duty to defend is broader than its duty to indemnify insurers will often issue a reservation of rights. (*Assurance Co. of America v. Haven* (Cal. App. 3d Dist. Feb. 6, 1995) 32 Cal. App. 4th 78.)

Purpose and legality of a reservation of rights

In order to both provide representation and defend an insurer will often defend under a reservation of rights. Under a reservation of rights an insurer uses reservations of rights letters to discharge its duty to defend while preserving right to contest coverage later. Courts are split on if reservation of rights letter automatically creates a conflict of interest that entitles policyholder to independent counsel that is selected by the policyholder but paid for by the insurer. (*San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.* (1984) 208 Cal. Rptr. 494.)

In California, the court in *Cumis* held that if the policyholder does not agree, after full disclosure, to dual representation then the insurer must pay the reasonable costs of independent counsel hired by the policyholder – even though there is common interest in finding non-liability. (Id. at 496, 498) (where Cumis sent out a reservation of rights letter denying coverage for intentional misconduct when plaintiff sought compensatory and punitive damages.) However, the insurer does not have to pay for counsel with respect to underlying claims where reservation of rights did not create a conflict. (*Native Sun Investment Group v. Ticor Title Insurance Co.* (1987) 189 Cal.App.3d 1265.) Additionally, the rule in *Cumis* applies only where the nature of the policyholder's conduct focused on in the underlying suit forms the basis of the coverage dispute. (*McGee v. Superior Court* (1985) 176 Cal.App.3d 221, 226.) When the reservation of rights is based on an issue that is extrinsic and independent to the issue of the policyholder's liability then no *Cumis*-type conflict will exist.

The holding in *Cumis* was further limited by California Civil Code section 2860.[i] Under California Civil Code section 2860 a conflict does not exist where an insurer denies coverage as to allegations or facts for which insurer denies coverage, but a conflict may exist where insurer reserves its rights on a given issue where the outcome of the coverage issue can be controlled by counsel first retained by insurer for defense of the claim. (Cal. Civ. Code §2860(b).) Additionally, no conflict exists for allegations of punitive damages or solely because insured is sued for an amount that is in excess of the insurance policy limits. (*Id.*) Further, when independent counsel is called for insurer can require insurer select counsel with at least five years of civil litigation practice and has errors and omissions coverage. (Cal. Civ. Code §2860(c).) The insurer's obligation to pay fees for selected independent counsel selected by insurer is limited to 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." (*Id.*)

Further, other jurisdictions create a broad protection of the policyholder when the insurer seeks to defend under a reservation of right. Alaska has rejected a two-counsel scheme where insurer pays for chosen counsel to defend portion of the lawsuit pertaining to intentional misconduct but retain their own counsel to act as co-counsel. (*CHI of Alaska, Inc. v. Employers Reinsurance Corp.* (Alaska 1993) 844 P.2d 1113). The court held the two-counsel scheme does not protect policyholder from the insurer gaining access to confidential information that it could use in a subsequent action against policyholder to determine coverage. (*Id.*)

However, some jurisdictions reject the idea that the policyholder need to select counsel in all conflict situations. These jurisdictions often hold that simply by enforcing strict ethical standards on defense counsel most conflict problems will be resolved, and therefore no bright line rule is needed. Model Rules 1.7[ii], 1.8(f)[iii], and 5.4(c)[iv] all hold defense counsel to high standards.

In this vein, the Washington Supreme Court imposed an enhanced duty of good faith on the insurer and standards of undivided loyalty and full disclosure on its selected defense counsel. (*Tank v. State Farm Fire & Casualty Co.* (Wash. 1986) 715 P.2d 1133.) The insurer has various options when defending under a reservation of rights: "(A) defend the insured and reserve the right to contest coverage; (B) sue for a declaratory judgment before undertaking the defense; or (C) require insured to pay for own defense, with guaranty to reimburse costs if final judgment establishes the insured's liability." (*McGreevy v. Oregon Mutual Insurance Co.* (Wash. 1995) 904 P.2d 731, 738.) The insurer can meet this criteria by:

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

greater concern for the insurer's monetary interest than for the insured's financial risk. (*Tank v. State Farm Fire & Casualty Co.* (Wash. 1986) 715 P.2d 1133, 1137.)

IV. Responses to Excess Policy Demands

The insurer owes the insured several duties regarding excess settlements and judgments. If the insured purchases excess insurances "[t]he primary insurer's duty to act with due care and in good faith does not disappear simply because the insured purchased excess insurance." (*Certain Underwriters of Lloyd's etc. v. Gen. Accident Ins. Co.* (7th Cir. 1990) 909 F.2d 228, 232.) "If the insured purchases excess coverage, he in effect substitutes an excess insurer for himself. It follows that the excess insurer should assume the rights as well as the obligations of the insured in that position." (*Ranger Ins. Co. v. Travelers Indem. Co.* (Fla. Dist. Ct. App. 1980). 389 So. 2d 272, 274–75.) Many courts substitute the excess insurer for the insured through equitable subrogation allowing excess insurers to have a cause of action when an insurer's bad faith settlement causes an excess judgment or settlement.

Duty to Defend

Unless the terms of the excess policy state otherwise, until the primary coverage is exhausted or otherwise no longer on the risk, the primary insurer owes the exclusive duty to provide the insured a defense against third-party claims. (*Signal Cos., Inc. v. Harbor Ins. Co.* (1980) 27 Cal.3d 359, 380; *see also Phoenix Ins. Co. v. United States Fire Ins. Co.* (1987) 189 Cal.3d 1511, 1528.) Even if excess policy does not expressly provide, the duty to defend shifts to the excess insurer when the primary coverage is exhausted. This obligation to defend is implied from its obligation to cover losses. (*Aetna Cas. & Sur. Co. v. Certain Underwriters at Lloyds of London* (1976) 56 Cal.3d 791, 804.) However, an excess policy may exclude any obligation to provide a defense, so long as they are clear and specific. (*Interstate Fire & Cas. Co. v. Stuntman, Inc.* (9th Cir 1988) 861 F2d 2013, 2015–2016.) Additionally, the excess policy may also require excess insurer's written consent before it will be liable for defense costs. [*see Signal Cos., Inc. v. Harbor Ins. Co.* (1980) 27 Cal.3d 359, 362–363 ; *Pacific Indem. Co. v. Fireman's Fund Ins. Co.* (1985) 175 Cal.3d 1191, 1201.)

Duty of Good Faith

The duty of good faith requires an insurer to "keep its insured reasonably well informed of the progress of the case, including settlement offers." (*Sobus v. Lumbermens Mutual Casualty Co.* (D. Md. 1975) 393 F. Supp. 661, 673, aff'd 532 F.2d 751 (4th Cir. 1976).) When an insurer fails to keep an insured well informed of a settlement offer is a factor in determining of the insurer has acted in bad faith. If an insurer acted in bad faith they may be liable over and above its policy limits. (*Scottsdale Insurance Co. v. Addison Insurance Co.* (Mo. 2014) 448 S.W.3d 818, 828.)

Duty to Make Reasonable Settlement Decisions

The insurer and the policyholder will often have conflicting interests when it comes to making settlement decisions. For claims within the policy limits, while insurers would like to

minimize the value of the claim, policyholders may not be as concerned because the insurer will cover everything. As a result, insurance policies almost always provide a policyholder can only settle at their own expense. Largely because settlement is restricted for policyholders the insurer owes a duty to the insured to reasonably settle when the opportunity is presented. This duty to settle is a part of the duty to indemnify.

Defense counsel has an independent duty to keep the insured informed of developments regarding settlements that may affect any excess insurer. Insured should be informed about any demand made for a sum in excess of policy limits so that they can have the opportunity to consider contributing to the excess amount to avoid litigation. (*State Farm Mut. Auto. Ins. Co. v. White* (1967) 248 Md. 324, 333.)

Direct Duties Between Primary and Excess Insurers

While excess insurers can often file equitable subrogation claims for a violation of the above duties all owed to the insured, very few jurisdictions recognize any direct duties between the primary and excess insurers. Courts have been very hesitant to give excess insurers greater rights than the insured, focusing instead on the theory of equitable subrogation. (*Truck Ins. Exch. V. Century Indem.* (Wash. 1995) 76 Wn. App. 527, 535.)

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[i] § 2860. Provision of independent counsel to insured; Conflicts of interest; Selection of counsel; Waiver of right to counsel

(a) If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel. An insurance contract may contain a provision which sets forth the method of selecting that counsel consistent with this section.

(b) For purposes of this section, a conflict of interest does not exist as to allegations or facts in the litigation for which the insurer denies coverage; 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. No conflict of interest shall be deemed to exist as to allegations of punitive damages or be deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits.

(c) When the insured has selected independent counsel to represent him or her, the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum qualifications which may include that the selected counsel have (1) at least five years of civil litigation practice which includes substantial defense experience in the subject at issue in the litigation, and (2) errors and omissions coverage. The insurer's obligation to pay fees to the independent counsel selected by the insured is limited to 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. This subdivision does not invalidate other different or additional policy provisions pertaining to attorney's fees or providing for methods of settlement of disputes concerning those fees. Any dispute concerning attorney's fees not resolved by these methods shall be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute.

(d) When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action. Any claim of privilege asserted is subject to in camera review in the appropriate law and

motion department of the superior court. Any information disclosed by the insured or by independent counsel is not a waiver of the privilege as to any other party.

(e) The insured may waive its right to select independent counsel by signing the following statement: "I have been advised and informed of my right to select independent counsel to represent me in this lawsuit. I have considered this matter fully and freely waive my right to select independent counsel at this time. I authorize my insurer to select a defense attorney to represent me in this lawsuit."

(f) Where the insured selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured. Nothing in this section shall relieve the insured of his or her duty to cooperate with the insurer under the terms of the insurance contract.

[ii] Rule 1.7 Conflict of Interest: Current Client:
(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. 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.
(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), 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.

[iii] 1.8(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:
(1) the client gives informed consent;
(2) there is no interference with the lawyer's independence of professional judgment or with the client-lawyer relationship; and
(3) information relating to representation of a client is protected as required by Rule 1.6.

[iv] 5.4(c) A lawyer shall not permit a person who recommends, employs, or pays the lawyer to render legal services for another to direct or regulate the lawyer's professional judgment in rendering such legal services.