

**(You've got to) fight for your right (to independent counsel) Who's defending who?**

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I. INTRODUCTION

The phrase “litigation insurance” is often used to describe liability insurance,<sup>1</sup> because the main purpose of that type of policy is lawsuit defense. A liability insurer has both the duty *and* the right to defend claims and suits that seek damages against its policyholder.<sup>2</sup> But in the real world where new policy exclusions seem to creep in after every decision that goes in policyholders’ favor, liability insurers don’t actually defend *every* claim and suit. And where they do accept a tendered defense, conflicts often arise. Case law that confirms the insured’s right to a lawyer that will truly zealously defend and represent *their* interests is under constant attack by insurers.

The interests of the insurer and the insured in a liability defense situation are not always the same. The insured is focused on being indemnified; the insurer is focused on minimizing liability and defense costs. And where the insurer has reserved its right to deny coverage down the road, many courts have held that the insured may be entitled to independent counsel.

There are number of potential conflicts that can arise when an insurer agrees to undertake the defense of a claim against its insured. The first is where an insurer with the duty to defend provides the insured with notice that it may have grounds to contest coverage, usually through issuing a reservation of rights letter. Another issue arises where the multiple insureds under the same policy, with possibly diverging interests, are

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<sup>1</sup> See Seth D. Lamden, 3 NEW AP. L. Ch. 17 (2014), Appleman on Insurance Scope; see also Timothy P. Law and Lisa A. Szymanski, *Reserving the Right to Contest Coverage under the Proposed Restatement of the Law of Liability Insurance*, Rutgers Center for Risk and Responsibility Conference on the Restatement of the Law of Liability Insurance, February 27, 2015 (forthcoming in Rutgers Law Journal).

<sup>2</sup> See Lorelie S. Masters, Jordan S. Stanzler, Eugene R. Anderson, *Insurance Coverage Litigation* (2d. ed. Supp. 2014 at §3.08, 3-88) (hereinafter “Masters and Stanzler”) (citing I. Jack P. Gibson & Maureen C. McLendon, *Commercial General Liability* at IV.T 1, 11, 19, 35, 45 (1996)).

represented by the same appointed defense counsel. When an insured is actually entitled to insurer-appointed defense counsel has been the subject of extensive litigation.

This article will briefly explore “tripartite” relationship, when an insured may be entitled to independent counsel, both in the scenario where an insurer defends despite possible coverage issues and where an insurer must defend multiple insureds under the same policy. We will examine California’s *Cumis*-counsel rule, which has been the subject of extensive litigation and confusion in the law with both theoretical and practical implications. And finally, we will remind policyholder counsel that, (cred to the Beastie Boys); you’ve got to fight for your right to independent counsel.

## II. THE TRIPARTITE RELATIONSHIP

In jurisprudence, the relationship between the insurer, the appointed defense counsel, and the insured is referred to as the “tripartite” relationship. Under this arrangement, defense counsel has essentially two clients, the insurer and the insured, with potentially (and often) differing interests in the subject litigation.<sup>3</sup> The insurer wishes to minimize its exposure, perhaps by compromising the insured’s coverage position, while the insured expects that the insurer will pay the costs of the defense and any resulting judgment, by bringing (or keeping) the claim within coverage under the policy.

The liability insurance contract creates a “dyadic” relationship, whereby the only two parties to the contract are the insurer and the insured and the appointed defense counsel is a third-party.<sup>4</sup> However, once defense counsel enters into a retainer agreement with the insurer, the relationship becomes “tripartite.”<sup>5</sup> The insurer has appointed defense counsel to fulfill its contractual obligation to its insured to defend it against a suit seeking

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<sup>3</sup> See generally Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 Duke L. J. 255 (1995).

<sup>4</sup> *Id.* at 269 (citing *Scribner v. AIU Ins. Co.*, 647 A.2d 48, 51 (Conn. Super. Ct. 1994) (refusing to subject attorney hired by insurance company to duty of good faith and fair dealing because the attorney was not a party to the contract of insurance)).

<sup>5</sup> *Id.* at 270.

damages, but perhaps also limit its eventual indemnity exposure by controlling the course of litigation, settlement decisions, and so forth.<sup>6</sup> This arrangement is complicated.

Insurance defense counsel, like all lawyers, has certain ethical duties and standards he or she must abide by, including, but not limited to representing his or her client zealously. This begs the question, who really is the client, the insurer or the insured? A majority of jurisdictions hold that the lawyer represents both the insurer and the insured, while a minority holds the insured is the sole client. Legal commentators differ on the logic of a “primary client” rule, though insureds certainly prefer it.<sup>7</sup>

The authority for the “primary client” rule and the position that the insurer (and by proxy the appointed defense counsel) must give at least as much consideration to the insured’s interests as it does to its own is found in both the law governing lawyers and the insurance law. To wit, the Model Rules of Professional Conduct Rule 1.7 states:

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...

Thus, if the interests of the insurer and the insured are adverse or that representation of both the insurer and the insured will limit the effective representation by defense counsel of one or both clients, the Model Rules require withdrawal (or for liability insurance purposes, such a conflict triggers the insured’s right to independent counsel).<sup>8</sup>

Another wrinkle in the “tripartite” relationship is that the insurer often believes it has the right to associate in the defense where the insured has retained independent counsel and is entitled to receive, upon request, information that is reasonably necessary to determine whether the defense is being adequately conducted.<sup>9</sup> However, the insurer is

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<sup>6</sup> See generally Tom Baker, *Liability Insurance Conflicts and Defense Lawyers: From Triangles to Tetrahedrons*, 4 Conn. Ins. L.J. 101.

<sup>7</sup> Contrast Baker, *supra* note 6 at 105 with Silver and Syverud, *supra* note 3 at 335.

<sup>8</sup> See Douglas R. Richmond, *Independent Counsel in Insurance*, 48 San Diego L. Rev. 857 (2011).

<sup>9</sup> See Jeffrey E. Thomas, 7 New Appleman on Insurance Law Library Edition § 72.02(5)(g) (Lexis 2012).

not normally entitled under the cooperation clause to confidential information shared by the insured that is protected by attorney-client privilege or work-product immunity.<sup>10</sup> This protection extends to the insured in its dealings with independent counsel, the rationale being that sharing certain information might prejudice the insured's coverage position and may incentivize the insurer to underdefend or sabotage the defense.

### III. WHEN AN INSURER MUST APPOINT INDEPENDENT COUNSEL

Due to the complexities of the "tripartite" relationship, independent counsel for the insured is sometimes necessary to eliminate actual or potential coverage and defense issues.<sup>11</sup> For example, many courts have held that where the underlying complaint against the insured contains some allegations that fall within coverage and others that may not, the insurer, while still having the duty to defend and the right to control the litigation, must appoint independent counsel.<sup>12</sup> Where there are common facts at issue in both the claim and coverage defense, there is the risk that the defense might be handled in a way that prejudices the insured to gain an advantage for the insurer.<sup>13</sup> Since the duty to defend is broader than the duty to indemnify, coverage and defense may be at odds.

An insurer that believes there may be both covered and uncovered claims presented in the underlying complaint will typically defend under a reservation of rights, meaning it agrees to undertake the defense but believes there is coverage for only some portion of the claim. Insurers often deal with this by seeking recoupment from the insured for defense costs apportioned to non-covered claims.<sup>14</sup> In the view of many insureds a reservation of rights alone is sufficient to warrant independent counsel.

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<sup>10</sup> See, e.g., *Eastern Airlines Inc. v. U.S. Aviation Underwriters, Inc.*, 716 So.2d 340, 343 (Fla. Ct. App. 1998); but see *Petrochemical Corp. v. Aetna Cas. And Sur. Co.*, 654 F. Supp. 1334 (D.D.C. 1986).

<sup>11</sup> See generally Ellen C. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 Md. L. Rev. 1.

<sup>12</sup> See, e.g., *Howard v Russell Stover, Inc.*, 649 F.2d 620 (8th Cir. 1981) Masters and Stanzler at 3-88.1.

<sup>13</sup> See 4 Ronald E. Mallen & Jeffrey M. Smith with Allison D. Rhodes, *Legal Malpractice* § 30.21 (2013 ed.) ("The prevailing rule is that the coverage issues must also bear upon a material liability issues, so that the manner of defense can influence coverage.").

<sup>14</sup> See Angela R. Elbert and Stanley C. Nardoni, *Buss Stop: A Policy Language Based Analysis*, 13 Conn. Ins. L.J. 61 (2007) (discussing, *inter alia*, *Buss v. Superior Court*, 16 Cal. 4th 35 (1997)).

It is interesting to note that under a reservation of rights, the carrier does not generally identify the specific portion of the policy as to which it is reserving its rights, yet is then free to pick and choose from all the policy provisions to deny coverage when the case is over. Why a reservation of rights is sufficient to deny coverage at the end of the case, yet insufficient, in the view of many insurers, to trigger the right to independent counsel at the beginning is an outstanding question in need of resolution. Thus, defense counsel's obligation ought to be to the defense of the claim and not to the insurer's coverage position. If it were, surely independent counsel would be necessary.

Alternatively, where the insurer is under an obligation to defend multiple insureds under the same policy, there may be cause to appoint independent counsel. This is because at some point during the litigation, it is likely that the insureds' interests will diverge, perhaps in a construction defect case where the contractor and sub-contractor are both insureds under the same liability policy. Perhaps the carrier decides to settle the underlying claims against the sub-contractor and then withdraw the defense, leaving the contractor, also a named insured, to fend for him or herself. Theoretically, this is quite easily remedied by the appointment of independent counsel for each insured.

#### IV. CALIFORNIA'S CONFUSING CUMIS JURISPRUDENCE

California presents a unique case, chiefly because the California Rules of Professional Conduct differ from the Model Rules of Professional Conduct with respect to whether an attorney may represent joint clients despite a conflict. The court in *San Diego Federal Credit Union v. Cumis Ins. Society, Inc.*<sup>15</sup>, relying on the sound approach to conflicts among multiple clients taken by the Rule 3-310 of the California Rules of Professional Conduct, held that an insured's right to independent counsel is triggered by "actual" and "potential" conflicts. The *Cumis* court explained:

“...[a] distinction between "potential" and "actual" conflicts of interest... [is] invalid and unworkable. Recognition of a conflict cannot wait until the moment a tactical decision must be made during trial. It would be unfair to the insured and

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<sup>15</sup> 162 Cal.App.3d 358 (1984).

generally unworkable to bring in counsel midstream during the course of trial expecting the new counsel to control the litigation. Contrary to *Cumis*' argument, the existence of a conflict of interest should be identified early in the proceedings so it can be treated effectively before prejudice has occurred to either party. It may well be in a given case special verdicts will not be requested or given, and other indicators of the basis of liability such as punitive damages will not come into play. Nevertheless, this often cannot be known until shortly before the case is submitted to the jury. By that time, it is normally too late to prevent prejudice.”<sup>16</sup>

Rule 3-310 of the California Rules of Professional Conduct, upon which the *Cumis* decision is largely based, prohibits an attorney from representing multiple clients whose interests are actually or potentially adverse.

Rule 3-310, entitled: Avoiding the Representation of Adverse Interests, reads:

(C) A member [of the State Bar of California] shall not, without the informed written consent of each client: (1) Accept representation of more than one client in a matter in which the interests of the clients potentially conflict; or (b) or (2) Accept or continue representation of more than one client in a matter in which the interests of the clients actually conflict...(emphasis added).

Thus, if there is no informed consent, a policyholder, under *Cumis* and the Rules of Professional Conduct has an unqualified right to independent counsel. The saying goes that one cannot serve two masters, thus the insurer-appointed defense counsel cannot zealously represent both the insurer and the insured. As if that were not enough support, California’s Insurance Code Section 2860 also reads, in relevant part:

(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...

Practitioners will attest to the fact that in the decades since the *Cumis* decision, insurers have become emboldened by decisions that seem to disregard the rationale for independent counsel in insurance coverage cases. Worse even, the fact that the California Insurance Code also speaks to the issue of where an insurer issues a reservation of rights, there may be a conflict of interest that warrants independent counsel.

Section 2860 reads, in relevant part:

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<sup>16</sup> *Cumis*, 162 Cal.App.3d at 371 (fn.7).

(b) ...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.

This is especially true where two or more insureds are subject to the same litigation and have potentially adverse interests and differing levels of culpability, such as a construction defect case with multiple potentially liable insureds. This was precisely the issue in the recent case of *Centex Homes v. St. Paul Fire and Marine Ins. Co. and St. Paul Mercury Co.*<sup>17</sup> In *Centex*, the insurer agreed to defend its insured, Oak Leaf Landscape, a subcontractor, and Centex Homes as a named additional insured, in a construction defect case. Given the distinct possibility that Oak Leaf and Centex Home's interest would diverge in the litigation, Centex Homes was denied independent counsel. Relying largely on *Dynamic Concepts, Inc. v. Truck Ins. Exchange*<sup>18</sup>, which incorrectly held that because there was no "actual" conflict of interest, but only a strong "potential" conflict of interest, the insured was not entitled to independent counsel as a matter of law, adding to the growing list of confusing *Cumis* jurisprudence.

## V. CONCLUSION

When an insured tenders defense of a claim or suit to an insurer, conflicts, ethical and practical issues can arise. The insurer may dispute coverage for some or all of the allegations in a complaint. The insurer may issue a reservation of rights letter that scares the insured and deprives them of the peace of mind that they're going to be financially okay. Insurer-appointed defense counsel may find themselves in a conflict between the interests of the insurer that is paying their bills and the policyholder that is relying on them to provide the best possible defense.

Insurers and insureds often differ over whether or not a conflict exists and whether it can be cured or warrants independent counsel. A clear rule, for example that reservation of rights letter *always* triggers the insured's right to insurer-paid independent

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<sup>17</sup> Case No. E060057, Court of Appeal, Fourth District) (petition for review to the California Supreme Court denied August 19, 2015).

<sup>18</sup> 61 Cal. App. 4th 999 (1998).

counsel would serve the interests of fairness and justice (and probably result in less litigation overall). Perhaps the same should be true where multiple insureds under the same policy are named in the same lawsuit. Insurers resist this simple solution, but the alternative is a murky rule that is decided on a case-by-case basis (as in California and elsewhere) and that has been harmful to insureds. The “tripartite” relationship is complicated and without a clear rule on when independent counsel is required, insureds often find themselves in a complex, unpleasant and expensive position regarding defense and coverage.