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INTRODUCTION

Labor-employment law has traditionally been a fairly specialized area of practice provided by certain "boutique" firms (some confining their practice solely on behalf of management as opposed to labor or vice versa) and specialized practice groups within larger firms. It is not unusual for a large employer to turn to a single one of these firms for all of its employment-related legal work and develop a long-term and extensive relationship with them. Particularly when a firm has numerous offices nationwide, the relationship may be one without any practical geographic limitations.

With the growing popularity of employment practices liability insurance ("EPLI") over the recent years, the question arises under those policies as to who controls the defense process, including the choice of counsel. Although there is no "generic" EPLI policy form, the major underwriters of this business all appear to be uniform, in that their policies' language clearly provides the insurer with the right and duty to defend and the right to select and appoint defense counsel on behalf of the insureds under the policy.

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That having been said, the insurer's rights in this regard are often tempered by a number of legal, as well as business and practical considerations. Given that the EPLI product is relatively new, there is presently no caselaw guidance specific to these policies. However, the issue has been frequently considered under other liability insurance policies, and the guidance provided by those decisions should in many respects be applicable to EPLI.

As EPLI policies are of the "duty to defend" variety, it is helpful to examine decisions construing the extent of the insurer's right to select defense counsel under commercial or comprehensive general liability and other types of policies that impose a duty to defend. Absent any significant coverage issues that might give rise to a conflict of interest between the insurer and its insureds, the insurer may generally rely on its policy contract language providing it with the right to select the insured's defense counsel.[1] When the insurer assumes the defense of its insured subject to a reservation of rights, however, one of the first significant issues presented for resolution is whether the insurer will be able to control the selection of defense counsel.

Although counsel who defends the insured, regardless of whether such counsel is selected by the insurer or the insured itself, will always owe its *primary* (if not *sole*) fiduciary duty to the insured as its client, counsel selected by the insurer also has an attorney-client relationship with the insurer as well.[2] It is this "secondary allegiance" that has caused some courts and commentators to hold that the insurer should be precluded from controlling the selection of counsel in most reservation of rights situations.[3] As will be discussed below, however, not every reservation of rights or assertion of a partial disclaimer of coverage should give rise to a relinquishment of what would otherwise be the right of the insurer to select defense counsel.[4]

This Article explores the law of three important jurisdictions with respect to this issue, namely, California, New York, and Illi-

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1. *See, e.g.*, Cardin v. Pacific Employers Ins. Co., 745 F. Supp. 330 (D. Md. 1990); McGee v. Superior Court, 221 Cal. Rptr. 421 (Cal. Ct. App. 1985); Maryland Casualty Co. v. Peppers, 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

2. *See* Doctors' Ins. Servs. Co. v. Superior Court, 275 Cal. Rptr. 674 (Cal. Ct. App. 1990), *review denied*, 1991 Cal. LEXIS 1342 (Cal. March 28, 1991); Illinois Mun. League Risk Management Ass'n v. Seibert, 223 Ill. App. 3d 864, 585 N.E.2d 1130, *appeal denied*, 145 Ill.2d 634, 596 N.E.2d 628 (1992).

3. *See generally* Kansas Bankers Sur. Co. v. Lynass, 920 F.2d 546 (8th Cir. 1990); Continental Ins. Co. v. Bayless & Roberts, Inc., 503 F.2d 1379 (9th Cir. 1974).

4. *See* Federal Ins. Co. v. X-Rite, Inc., 748 F. Supp. 1223 (W.D. Mich. 1990).

nois. This type of analysis provides an illustration of how the courts have addressed the process of selecting counsel. As noted above, courts have not yet addressed this issue in the context of EPLI coverage, but a look back at how the issue historically has been treated by the courts nevertheless is instructive. This Article also discusses some of the practical dynamics of the EPLI relationship and provides some insight into how this issue might be addressed in the EPLI arena.

I. CALIFORNIA

Probably the most notorious judicial decision in this area was the commonly-referenced *Cumis* case in California in the mid-1980s.[5] In summary, the *Cumis* court held that once the insurer reserved rights, it relinquished the right to unconditionally select counsel and had to reimburse the insured for the costs of counsel it retained to defend itself and protect its potentially uninsured interest.

Cumis, however, has been clarified by both statute, at section 2860 of the California Civil Code and subsequent judicial decisions.[6] For example, it is now clear that not every reservation of rights gives rise to the right to independent counsel but rather only those reservations on coverage issues which, by their nature, can be influenced by the way the defense is conducted.[7] Perhaps the prime example of this would be a reservation to deny on the basis of intentional misconduct. Although it would be to the mutual advantage of insured *and* insurer to support a position of no liability, if there were to be liability on the part of the insured to the claimant, the insurer would be in a better position if the insured's culpable conduct was intentional, as opposed to a lesser degree such as negligence.

However, the mere fact that the insurer asserts the position that there would be no coverage for punitive damages, if awarded, does not give rise to the right to *Cumis* counsel.[8] Likewise, the Cal-

5. San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc., 208 Cal. Rptr. 494 (Cal. Ct. App. 1984).

6. *See, e.g.*, Centennial Ins. Co. v. Murat, 253 Cal. Rptr. 914 (Cal. Ct. App. 1988) (Not officially published); McGee v. Superior Court, 221 Cal. Rptr. 421 (Cal. Ct. App. 1985).

7. This rule is not particular to California insurance jurisprudence. *See, e.g.*, Steel Erection Co. v. Travelers Indem. Co., 392 S.W.2d 713 (Tex. Civ. App. 1965).

8. CAL. CIV. CODE § 2860(b) (1993); *see also* Parker v. Agricultural Ins. Co., 440 N.Y.S.2d 964 (N.Y. Sup. Ct. 1981).

ifornia Civil Code now provides that no conflict of interest exists merely because an insured is sued for an amount in excess of insurance policy limits.[9]

Further, the insurer has some protection from abusive billings by *Cumis* counsel. Courts have held that such counsel are only entitled to be reimbursed at prevailing rates in effect by the insurer for its own panel counsel in the particular geographic area and area of practice.[10]

A California appellate decision, rendered after both the decision in *Cumis* and enactment of the current version of section 2860 but commenting upon the obligations of an insured without regard to that decision and statute, further clarifies the parties rights and obligations in this area.[11]

> [T]he duty of good faith imposed upon an insured includes the obligation to act reasonably in selecting as independent [defense] counsel an *experienced* attorney qualified to present a meaningful defense and willing to engage in *ethical billing practices susceptible to review at a standard stricter than that of the marketplace*.[12]

II. NEW YORK

Unlike California, the general rule in New York has not been codified but is embodied in two landmark decisions both rendered by the New York Court of Appeals. The first, *Prashker v. United States Guarantee Co.*,[13] dates back to the 1950s and the second, *Public Service Mutual Insurance Co. v. Goldfarb*,[14] was issued approximately twenty-five years later, in 1981. These decisions leave little doubt that New York law in this area is very much like that of California: if a conflict of interest exists between the insured and the insurer with respect to the defense of a claim, the insured is entitled to counsel of its own choosing.

This rule has been amplified, however, by subsequent decisions of other courts, including the New York state intermediate appel-

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9. Courts outside California have ruled similarly. *See, e.g.*, Zieman Mfg. Co. v. St. Paul Fire and Marine Ins. Co., 724 F. 2d 1343 (9th Cir. 1983); *Parker*, 440 N.Y.S.2d at 964.

10. CAL. CIV. CODE § 2860(a).

11. Center Found. v. Chicago Ins. Co., 278 Cal. Rptr. 13 (Cal. Ct. App. 1991).

12. *Id.* at 21 (emphasis added).

13. 154 N.Y.S.2d 910, 136 N.E.2d 871 (1956).

14. 444 N.Y.S.2d 422, 425 N.E.2d 810 (1981).

late courts and federal courts interpreting New York law.[15] As discussed below, where courts have departed from or otherwise expanded the seemingly absolute rule enunciated by the New York Court of Appeals, they have done so because of distinguishable policy language or compelling factual settings.

As in California, the New York courts have not specifically addressed this issue in the context of an employment practices policy. However, there is no reason to suspect that the *Prashker* and *Goldfarb* analyses would be applied any differently to an employment practices policy than they have been to other duty to defend policies.

To provide some background, *Prashker* involved a coverage issue under a liability policy that insured, among other things, a private plane owned by a corporation. During one flight, the plane was piloted by Nathan Prashker, accompanied by a single passenger. Prashker held a license to pilot an aircraft under visual flying conditions, but he was not licensed to fly under instrument flying conditions. The plane took off in dense fog and ultimately crashed, killing both people.

The passenger's heirs filed suit against Prashker's estate, and the estate sought defense and indemnity coverage under the liability policy. The insurer denied any obligation under the policy, on the ground that the policy excluded coverage for any insured who operated an aircraft in violation of Civil Aeronautics Administration regulations. Prashker's operation of the plane in foggy conditions did indeed constitute such a violation. A declaratory judgment action ensued.

The court concluded that some of the allegations against Prashker's estate were based on negligence and thus potentially would be covered under the policy. Other allegations, however, were grounded upon regulatory violations, which were excluded from coverage. Notwithstanding the fact that the complaint pled potentially covered allegations, the insurer argued that it could not be expected to defend the suit because,

> [I]t would subject to divided loyalty any attorneys who might defend the action, in that their duty to the assureds would be to endeavor to defeat recovery on any ground, whereas their duty to the insurance company would be to defeat recovery only upon such grounds as might render the insurance company liable.[16]

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15. See *infra* notes 16 to 30.

16. *Prashker*, 154 N.Y.S.2d at 917, 136 N.E.2d at 876.

The court, however, easily resolved this problem by noting that,

> If any such conflict of interests arises, as it probably will, the selection of the attorneys to represent the assureds should be made by them rather than by the insurance company, which should remain liable for the payment of the reasonable value of the services of whatever attorneys the assureds select.[17]

New York's Court of Appeals thus crafted the general rule that continues to stand today, albeit with considerable massaging in subsequent decisions.

Approximately twenty-five years later, the New York Court of Appeals reiterated this rule of law in the *Goldfarb* decision.[18] In that case, an insured dentist sought coverage under his professional liability policy for his defense in a suit by a former patient charging sexual abuse. The insurer denied coverage on the grounds, among others, that the complaint alleged criminal acts, which were uninsurable under New York's public policy.

The court drew a distinction, however, between a criminal act that caused an intended injury (which is uninsurable) and a criminal or intentional act that caused an unintended injury (which is insurable).[19] The issue of whether the insured committed uninsurable acts was one that could only be determined after the factual record of the case was fully developed. In the meantime, the insurer owed the insured a defense in the action.

Given that the insurer's interest in defending the suit was in conflict with the insured's — the insurer being liable only upon a showing that the insured's acts caused unintended injuries — the insured was entitled to a defense by an attorney of his own choosing. The reasonable fees of such attorney were to be paid by the insurer.

In a footnote, the *Goldfarb* court provided some additional guidance on the issue of when a conflict necessitating separate counsel arises. The court stated:

> That is not to say that a conflict of interest requiring retention of separate counsel will 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 he defeat liability only upon grounds which would

17. *Id.*
18. *Goldfarb*, 444 N.Y.S.2d 422, 425 N.E.2d 810.
19. *Id.* at 401, 425 N.E.2d at 815.

> render the insurer liable. When such a conflict is apparent, the insured must be free to choose his own counsel whose reasonable fee is to be paid by the insurer. On the other hand, where multiple claims present no conflict — for example, where the insurance contract provides liability coverage only for personal injuries and the claim against the insured seeks recovery for property damage as well as for personal injuries — no threat of divided loyalty is present and there is no need for the retention of separate counsel. This is so because in such a situation the question of insurance coverage is not intertwined with the question of the insured's liability.[20]

The court set "parameters" for determining whether a conflict of interest exists requiring the retention of separate counsel in a given case. The scope of these parameters, which was not precisely defined by the *Goldfarb* court, has been the subject of much debate since the *Goldfarb* decision.

One later decision held that so long as a *potential* conflict existed between the insured and the insurer, independent counsel was necessary.[21] In that case, the face of the complaint only contained allegations of negligence. The insurance company conceded, however, that it intended to investigate the matter with an eye towards avoiding coverage by showing that the insured acted intentionally.

Upon considering prior decisions in which the above footnote in *Goldfarb* was at issue, the court held that the insurance company was required to look beyond the complaint to determine whether, as a factual matter, a conflict necessitated independent counsel. The inquiry did not end merely because the complaint itself contained no allegations of intentional misconduct. The insurance company could salvage its right to appoint counsel only if no "extraneous" conflicts potentially could arise. Since the specter of a denial of coverage loomed over the insured, independent counsel was warranted.

Separate and apart from the issue of whether a conflict exists because covered and non-covered claims are asserted against the insured, there is the issue of litigation strategy. What if the allegations in the complaint are completely covered, but the insured and the insurer simply have different interests in *how* to defend the claim? Does that situation create a conflict that would require the retention of separate counsel? One New York appellate court an-

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20. *Id.* at 401, 425 N.E.2d at 815.

21. Vanguard Ins. Co. v. Guagenti, 599 N.Y.S.2d 215, 216 (N.Y. Sup. Ct. 1993) (citing Baron v. Home Ins. Co., 492 N.Y.S.2d 50 (N.Y. Super. Ct. 1985)).

swered that question in the affirmative and held that the insurer could not defeat its insured's right to select independent counsel by arguing that collectively they were united in interest in their pursuit of defeating the claimant. The court observed:

> In practically all, if not all cases, the insured and the insurer will have a common interest in defeating the claim made against the insured. What changed the rights of the insurer and the insured in those cases were the conflicts arising from their *divergent* interests, in how they would prefer to go about defeating such claims. The interests of [the insured] and [the insurer] diverged seriously here, though each wished to defeat the claim .... [The insurer], having insured the title of a heavily mortgaged property, could proceed leisurely. [The insured] needed a quicker resolution to keep open the possibility of refinancing, to retain customers and employees, and to stay in business. There was a crucial conflict of interests between them, and [the insured] had the right to its own attorneys.[22]

As in California, the New York courts thus have moved beyond an assessment of coverage issues in evaluating whether independent counsel is needed. It is clear that if counsel's tactical decisions in the litigation can adversely impact the interests of either the insured or the insurer, counsel must be independent.[23]

This issue of divergence in litigation strategy is present in many EPLI cases. Take the example of a claim for sexual harassment against a prominent business person who works for a well known company with a "clean" reputation. The insured in that case may look to resolve the matter quickly and quietly, and may be willing to settle the claim for a larger amount for public relations reasons. The EPLI insurer, on the other hand, may want to litigate the matter in order to discredit the plaintiff's case, thus driving down the settlement value of the claim. Here, under the rationale of *69th Street* and *Ladner*, independent counsel may be warranted although the question remains as to whether the insurer is obligated to pay for that separate representation under the applicable liability insurance policy.[24]

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22. 69th St. and 2nd Ave. Garage Assocs., L.P. v. Ticor Title Guar. Co., 622 N.Y.S.2d 13, 14 (N.Y. App. Div. 1995) (emphasis added).

23. Ladner v. American Home Assurance Co., 607 N.Y.S.2d 296, 298 (N.Y. App. Div. 1994).

24. Even where an independent counsel is in place, the insurer may nonetheless maintain effective control of the litigation and settlement process. Although neither a New York decision nor one in which selection of counsel was directly at issue, the recent California appellate decision in Western Polymer Technology v. Reliance Ins. Co.,

Having discussed some of the situations where a conflict was found to exist, the next phase of the defense process is the selection and retention of competent legal counsel to represent the insured. Here, an interesting issue arises as to whether the insurance company may have any role in the selection of counsel.

In *New York State Urban Development Corp. v. VSL Corp.*,[25] the United States Court of Appeals for the Second Circuit, interpreting New York law, held that the insurer was indeed entitled to participate in the selection process. The professional liability policy at issue in *VSL* provided that the insurer would pay "all claims expenses" that were incurred in connection with a claim made against the insured. Significantly, the policy defined "claims expenses" as including fees charged by an attorney designated by the insurer or by an attorney chosen by the insured with the written consent of the insurer.[26]

In *VSL*, the parties agreed that a conflict did indeed exist. The only issue before the court was whether the above provision permitted the insurer to participate in the selection of counsel. The court agreed with the insurer, noting that the public policy considerations underlying *Prashker* and *Goldfarb* did not override the contractual provision in the policy. In this regard, the court stated:

> It is not inherently objectionable to permit an insurer to participate in the selection of independent counsel for the insured as long as the insurer discharges its obligation in good faith and the attorney chosen is truly independent and otherwise capable of defending the insured.
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> . . . .
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> The participation of the insurer in the selection process does not automatically taint the independence of chosen counsel.[27]

The court further held that the insurer did not act in bad faith by refusing to permit counsel designated by the insured to defend the claim. The reason was that counsel had represented the insured in the coverage action against the insurer and, accordingly, was hos-

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38 Cal. Rptr. 2d 78 (Cal. Ct. App.) *review denied*, 1995 Cal. LEXIS 2612 (Cal. April 13, 1995) is instructive. In that case, despite the fact that the insured was being defended by a so-called *Cumis* counsel under section 2860, the insured was not able to preclude the insurer from settling a claim in an amount and manner that allegedly injured the insured's business reputation and impaired its ability to recover on certain cross-claims against other parties.

25. 738 F.2d 61 (2d Cir. 1984).

26. *Id.*

27. *Id.* at 65-66.

tile towards the interests of the insurer. On this issue, the court stated, "it was not unreasonable for [the insurer] to insist on counsel independent to both itself and [the insured]."[28]

Additionally, with specific regard to the facts of the *VSL* case, the insurer's willingness to accommodate the insured appeared to weigh heavily in the court's reasoning. The insurer had designated an unquestionably competent and experienced firm, with whom it had no previous dealings, as independent counsel. Alternatively, the insurer afforded the insured the opportunity to submit a list of proposed counsel to the insurer from which one would be chosen. The insurer's manifested desire to "do the right thing" undoubtedly cast a favorable light on its position.

Since *VSL* was decided, insurance companies have attempted to invoke the rule allowing them to have meaningful input in the selection of counsel. To their dismay, however, the *VSL* holding has been limited to its facts in subsequent decisions. For example, in *Emons Industries, Inc. v. Liberty Mutual Insurance Co.*,[29] the policy contained a "duty to defend" provision but lacked any requirement that the insured obtain the insurer's consent before retaining counsel. In the court's view, that fact alone distinguished *Emons* from *VSL*, and the insurer was not permitted to participate in counsel's designation.[30]

III. ILLINOIS

Illinois law, like that of New York and California, generally provides that if a conflict of interest is created by the insurer reserving its rights, the insured is entitled to assume control of its own defense, and the insurer must pay reasonable costs of defense incurred by independent counsel retained by the insured.[31]

"In determining whether a conflict of interest exists, Illinois

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28. *Id.* at 66.

29. 749 F. Supp. 1289 (S.D.N.Y. 1990).

30. Another distinguishing feature of *Emons* was that the insurer sought to replace counsel who had been defending the underlying action, an exceedingly complex matter, for several years. The court found that to allow the insurer to "pull the plug" on its insured at that juncture would cause irreparable harm to the insured. *Id.* at 1295.

31. *See, e.g.*, Thornton v. Paul, 74 Ill. 2d 132, 384 N.E.2d 335 (1978); Nandorf, Inc. v. CNA Ins. Co., 134 Ill. App. 3d 134, 479 N.E.2d 988 (1985); O'Bannon v. Northern Petrochemical Co., 113 Ill. App. 3d 734, 447 N.E.2d 985 (1983); Clemmons v. Travelers Ins. Co., 88 Ill. 2d 469, 430 N.E.2d 1104 (1981);. *See also* Maryland Casualty Co. v. Peppers, 64 Ill. 2d 187, 355 N.E.2d 24 (1976); Illinois Masonic Medical Ctr. v. Turegum Ins. Co., 168 Ill. App. 3d 158, 522 N.E.2d 611 (1988) (specifically referring to "reasonable" costs). .

courts have considered whether, in comparing the allegations of the complaint to the policy terms, the interest of the insurer would be furthered by providing a less than vigorous defense to those allegations."[32] The courts have identified two situations as creating conflicts of interest so great as to require independent counsel: claims alleging both covered and uncovered loss and claims where there are conflicts between multiple parties insured by the same insurer. Most frequently, conflicts will exist when allegations of both covered and uncovered loss are made, creating the situation where proof of certain facts would shift liability from the insurer to the insured.

Several cases illustrate the analysis employed by the Illinois courts in determining whether an insured is entitled to independent counsel. In *Maryland Casualty Co. v. Peppers*,[33] the Supreme Court of Illinois found a conflict where the insurer on a homeowner's policy was required to defend an underlying personal injury action in which allegations of negligent conduct (insured) and allegations of intentional injury (uninsured) were made. The court reasoned that if the insured is held responsible, it would be in his interest to be found negligent, which, under the terms of the policy would place the financial loss on the insurer. On the other hand, it would be to the insurer's interest to have a determination that the insured committed an intentional act, thus excluding the resulting loss from coverage. In these situations, as appears to be the case in California and New York, it is not necessary for the insured and insurer to be complete adversaries or for mutually exclusive theories of recovery to be advanced.[34] For example, in *Pepper Construction Co. v. Casualty Insurance Co.*, the court refused to dissolve a preliminary injunction requiring the insurer to relinquish control of the defense and reimburse the insured for defense costs.[35] The underlying dispute in the case involved a contract between plaintiff, Pepper Construction Company, and Marshall Field & Co. to construct a store. Plaintiff was the general contractor and had used various subcontractors. After construction was completed, sections of the store

32. *See* Pepper Const. Co. v. Casualty Ins. Co., 145 Ill. App. 3d 516, 517, 495 N.E.2d 1183, 1184 (1986); *Nandorf*, 134 Ill. App. 3d at 137, 479 N.E.2d at 992; County of Massac v. United Stated Fidelity & Guar., 113 Ill. App. 3d 35, 43, 446 N.E.2d 584, 590 (1983).

33. 64 Ill. 2d 187, 355 N.E.2d 24 (1976).

34. *See, e.g.*, *Pepper*, 145 Ill. App. 3d at 519, 495 N.E.2d at 1185; *Nandorf*, 134 Ill. App. 3d at 139, 479 N.E.2d at 993.

35. *Pepper*, 145 Ill. App. 3d at 520, 495 N.E.2d at 1186.

roof collapsed under heavy snowfall. At the time of the collapse, the plaintiff was insured by defendant Casualty. Marshall Field filed suit against the plaintiff and its subcontractors to recover consequential damages and repair costs paid to plaintiff.

Casualty acknowledged liability coverage for the consequential damages but denied coverage for work performed by the plaintiff. It argued that given its acknowledgment of liability for the consequential damages, a conflict was not created as its interests were not clearly opposed to the insured's, and in fact its acknowledged liability gave it a greater interest in the insured's defense. The court found this argument to be without merit. The insured's interest was in a finding that it was vicariously liable for work performed by a subcontractor, since in that event, Casualty was required to indemnify it under the terms of its policy. In contrast, Casualty's interest was in a finding that the insured's liability was based on work Pepper performed, as this was not covered. The court found an "obvious" conflict between the insurer and insured with regard to the repair costs, stating:

> The particulars of the conflict of interest do not matter, only the fact that there is a conflict at all. The insured has the right to be defended by counsel of his own choosing. A ruling that required an insured to be defended by what amounted to his enemy in the litigation would be foolish.[36]

In *Perkins Insurance Co. v. Home Insurance Co.*,[37] the court rejected the insured's argument that a conflict was created by the fact that the insurer was interested in keeping litigation costs to a minimum, while the insured wished to obtain a full and vigorous defense. The court emphasized that Illinois has recognized only two situations where the conflict of interest was so great as to require independent counsel, and these facts did not fit within either exception.[38] This is completely at odds with the *VSL* case discussed above.

Likewise, punitive damages do not necessarily constitute a conflict entitling the insured to independent counsel. In *Nandorf, Inc. v. CNA Insurance Co.*,[39] the complaint in the underlying action sought a large amount of punitive damages ($100,000) and a rela-

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36. *Id.* at 520, 495 N.E.2d at 1185 (quoting Murphy v. Urso, 88 Ill. 2d 444, 454, 430 N.E.2d 1079, 1084 (1981)).

37. 134 Ill. App. 3d 31, 479 N.E.2d 1078 (1985).

38. *Id.* at 34, 479 N.E.2d at 1081.

39. 134 Ill. App. 3d 134, 479 N.E.2d 988 (1985).

tively small amount of compensatory damages ($5,000). The insurer disclaimed liability only for the punitive damages. While the insured and insurer shared a common interest in a finding of no liability, the court reasoned that their interests diverged if the insured was found liable. Under those circumstances, the insurer's interest would have been just as well served by an award of minimal compensatory damages and substantial punitive damages. As a result, the insurer had an interest in providing a less than vigorous defense to the allegations supporting an imposition of punitive damages. Although the court found a conflict existed based on the facts before it, it stated:

> Our finding that a conflict of interest existed in the instant case is not meant to imply that an insured is entitled to independent counsel whenever punitive damages are sought in the underlying action. Under the peculiar facts and circumstances of this litigation, punitive damages formed a substantial portion of the potential liability . . . . Notwithstanding the common interest of both insurer and insured in finding total non-liability in the third party action, the remaining interests of the two conflicted to such an extent as to create an actual ethical conflict of interest warranting payment of the insured's independent counsel by the insurer.[40]

The court in *Illinois Municipal League Risk Management Association v. Seibert*, after discussing *Nandorf*, said "the proportionality between compensatory and punitive damages should not be a guiding factor" in determining whether a conflict of interest exists.[41] The underlying litigation in this case involved an action against Seibert, a police officer, for violations of section 1983 of the Civil Rights Act which allegedly occurred during an arrest. The plaintiff sought $10,000,000 in compensatory and $5,000,000 in punitive damages. The Association (a self-insurance program for municipalities) denied liability for punitive damages. The court found a conflict existed, as the Association could benefit by a finding that Seibert's conduct justified a punitive damage award since the Association could be required to pay only minimal compensatory damages, while Seibert could be personally liable for a large punitive damage award. Further, as Seibert noted, punitive damages can be awarded in civil rights litigation without proving actual damages.[42]

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40. *Id.* at 140, 479 N.E.2d at 993-94.

41. 223 Ill. App. 3d 864, 875, 585 N.E.2d 1130, 1137, *appeal denied*, 596 N.E.2d 1 (1992).

42. *Id.* at 876, 585 N.E.2d at 1138.

However, the United States Court of Appeals for the Seventh Circuit in *Tews Funeral Home, Inc. v. Ohio Casualty Insurance Co.*[43] found that although plaintiffs in the underlying case claimed a large amount of punitive damages ($25 million in each count) as well as treble damages, no conflict was created. The court distinguished *Nandorf* from the case before it, stating: "it is conceivable the plaintiffs' request for compensatory damages 'as proven' might result in a large award of compensatory damages."[44]

Illinois courts have also decided that, contrary to the New York court's analysis in *Vanguard Insurance Co. v. Guagenti*[45] an insurer's interest in negating policy coverage does not in and of itself create a sufficient conflict to give rise to independent counsel.[46] For example, in *Shelter Mutual Insurance Co. v. Bailey*, the court found "a conflict of interest cannot be inferred merely because an insurance company is asserting noncoverage in a separate suit. The test is whether or not there are conflicting interests based upon the allegations found in the complaint."[47] Here, the defendant in the underlying action was found guilty of battery in a criminal proceeding. The victim of the battery filed a civil suit alleging a cause of action for negligence. The insurer provided a defense but filed a declaratory judgment action asserting that there was no coverage under either its automobile or homeowner's policies.

The insured alleged this situation created a conflict of interest which entitled him to independent counsel. The court disagreed, finding that there was nothing in the allegations of the complaint showing the interests of the insurer would be furthered by providing a less than vigorous defense. The interests of the parties were identical, i.e., to defeat the claim or minimize the damages recovered.

In contrast, the court in *Royal Insurance Co. v. Process Design Associates, Inc.*, looked beyond the allegations in the complaint and found that a conflict was created based upon the actions of the insurer.[48] Royal, the general liability insurer, brought suit against its insured and an excess insurer, seeking declaratory judgement that it

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43. Tews Funeral Home, Inc. v. Ohio Casualty Ins. Co., 832 F.2d 1037 (7th Cir. 1987).

44. *Id.* at 1047.

45. 599 N.Y.S.2d 215 (N.Y. Super. Ct. 1993), see *supra* note 21 and accompanying text.

46. Shelter Mutual Ins. Co. v. Bailey, 160 Ill. App. 3d 146, 154, 513 N.E.2d 490, 496 (1987).

47. *Id.*

48. 221 Ill. App. 3d 966, 582 N.E.2d 1234 (1991).

was not contractually obligated to a provide defense or indemnity coverage to the insured. In the underlying actions, two employees filed personal injury suits against the insured, Process Design; both alleged violations of the Illinois Structural Work Act and common law negligence.

Royal sent a letter to Process stating it was defending the complaints because of the allegations of negligence and further advised that should the complaints be amended to include allegations of professional negligence, there might be a question as to whether or not Royal would continue to defend the actions, given that the policy contained a professional liability exclusion. Royal contended that no conflict existed because the underlying complaints never made allegations of professional negligence. Thus, when comparing the allegations in the complaint to the policy provisions, its interests could not have been furthered by a less than vigorous defense. However, the court found that Royal's actions during the time it defended the case belied this argument, stating:

> [D]efendants urge that Process was prejudiced by Royal's assumptions of its defense. Defendants maintain that, not only did Royal not advise Process of its intention of reserving the professional negligence exclusion, but Royal then undertook Process' defense for over three years while attempting to find a way in which Process might be found professionally negligent, thereby relieving Royal of liability. For support, defendants point to the several letters and memos written by Royal which indicate that, throughout its defense of Process, it was working towards discovering a way to invoke its professional liability exclusion, thus immunizing itself from liability to Process.[49]

Consequently, the court found that Royal was estopped from claiming it was not obligated to indemnify Process because of its failure to advise Process of the conflict of interest and its failure to properly reserve its rights. As previously mentioned, the second situation in which Illinois courts have recognized conflicts of interest is when multiple parties are insured by the same insurer. For example, in *Murphy v. Urso*,[50] the Supreme Court of Illinois found that a conflict requiring independent counsel arose when an injured passenger in a vehicle sued both the owner (a preschool) and operator of the vehicle (driver for preschool).[51] The operator's negli-

49. *Id.* at 976, 582 N.E.2d at 1241.
50. 88 Ill. 2d 444, 430 N.E.2d 1079 (1981).
51. *Id.*

gence appeared clear, leaving the owner's primary defense that the vehicle was operated without its permission at the time of the accident.

The insurer controlled the defenses of both defendants, and their interests were diametrically opposed. The owner's best defense was to show that the operator did not have permission to use the bus at the time of the accident, thus, shifting all liability to him, while the operator's best defense was to establish permission, thus shifting the risk of loss to the owner (and ultimately to the insurer, which created an additional conflict). Given this conflict, the operator was entitled to independent counsel.[52] In the employment context, multi-party conflicts will most likely be present in sexual harassment cases, where both the employer and alleged harasser are named as defendants. The employer is likely to argue that the alleged harasser acted outside the scope of his or her employment, and thus, the employer should not have liability for the illicit conduct.

Finally, Illinois courts have discussed several ways in which a conflict can be resolved in lieu of appointing independent counsel. The insurer can, of course, waive its coverage defenses and defend without asserting a reservation of rights. Alternatively, the insured, after full disclosure of the conflicts, can accept the defense of counsel appointed by the insurer.[53] According to the court in *Royal*, "[i]f the insurer has adequately informed the insured of its election to proceed under a reservation of rights, and the insured accepts the insurer's tender of defense counsel the insurer has not breached its duty of loyalty and is not estopped from asserting policy defenses."[54] A declaratory judgment action may also be available to the insured in some instances depending on the nature of the con-

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52. Note that the driver in the case was not a named insured under the policy. The court noted that, "[i]t makes no difference that here the conflict was with a putative insured instead of directly with the named insured." *Id.* at 444-45, 430 N.E.2d at 1084.

53. Similarly, in this regard, CAL. CIV. CODE § 2860(e) (1993) provides:

> 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."

Id.

54. Royal Ins. Co. v. Process Design Assocs., Inc., 221 Ill. App. 3d 966, 973-74, 582 N.E.2d 1234, 1239 (1991) (citing Cowan v. Ins. Co., 22 Ill. App. 3d 883, 896, 318 N.E.2d 315, 326 (1974)).

flict at issue.[55] However, it will not be appropriate in those circumstances where the coverage issue is closely or directly connected to the issue of the insured's liability in the underlying action.[56]

If the insurer assumes the defense under a reservation of rights and fails to advise the insured of the conflict created, it is estopped from denying coverage according to the *Royal* court.[57] Similarly, in *Peppers*, the Supreme Court of Illinois stated, "[i]f, however, by the insurer's assumption of the defense the insured has been induced to surrender his right to control his own defense, he has suffered a prejudice which will support a finding that the insurer is estopped to deny policy coverage."[58]

While Illinois courts seem uniform in permitting the insured to select independent counsel, the Seventh Circuit in *Tews Funeral Home*, found the insurer's providing a short list of reputable and qualified counsel from which the insured could select its defense counsel to be a reasonable compromise to the disputed issue of counsel selection.[59]

IV. CONCLUSION

Turning away from the legal considerations, what practical dynamics operate within the EPLI relationship between insurer and insured to help assure both parties that their interests will be served by selection of a competent, cooperative, and cost-effective defense counsel?

While defense counsel retained by the insurer can never place the interests of the insurer above that of the insured when those interests conflict, it is generally recognized that such counsel also

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55. *But see* Village Management, Inc. v. Hartford Accident & Indem. Accident Co., 662 F. Supp. 1366, 1373 (N.D. Ill. 1987), which seems to state that this alternative should not be pursued when a conflict of interest prevents an insurer from undertaking the insured's defense.

56. Thornton v. Paul, 74 Ill. 2d 132, 157, 384 N.E.2d 335, 345-46 (1978). In this regard, the Illinois Supreme Court said:

Requiring the injured party to appear in the declaratory judgment action between the insurer and the insured may deprive the injured party of his choice of forum and time for bringing suit. Furthermore, he would appear as a defendant rather than as a plaintiff, which may alter the burdens of proof and going forward with the evidence.

Id. (citing, Note, *Use of the Declaratory Judgment To Determine a Liability Insurer's Duty to Defend—Conflict of Interests*, 41 IND. L.J. 87, 101 (1965)).

57. *Royal*, 221 Ill. App. 3d at 977-78, 582 N.E.2d at 1242.

58. Maryland Casualty Co. v. Peppers, 64 Ill. 2d 187, 195, 355 N.E.2d 24, 29 (1976).

59. Tews Funeral Home, Inc. v. Ohio Casualty Ins. Co., 832 F.2d 1037, 1039 (7th Cir. 1987).

owes certain duties to the insurer. As a practical matter, one cannot lose sight of the reality that such counsel are retained on a regular basis by the insurer and their long-term economic interests depend upon the relationship with the insurer, and not the insured.

Even so, it is not panel counsel's role to assist the insurer in investigating coverage issues or to become an advocate for the insurer's coverage position. In fact, panel counsel must be extremely circumspect in how it handles the communication of any information to the insurer that may impact adversely on coverage of the insured.

Nonetheless, this does not imply that defense counsel retained by the insurer cannot effectively represent the insured's interest even where the defense is being provided pursuant to a significant reservation of rights.[60] Just as both the insurer and the counsel it selects to defend the insured owe duties and obligations to the insureds being defended, the insurer is not without certain protections of its own legitimate interests when the defense counsel is one selected by the insured. In this regard, it may be helpful to consider liability policies such as those in the directors' and officers' liability ("D & O") area and other policies that do *not* afford the insurer the right and duty to defend and to select counsel. Under those policies, however, the insurer may nonetheless have an obligation to pay or reimburse the costs of defense.

To protect the insurer's interests under these policies, the insurer will usually employ policy language to the effect that the insured's right to select counsel is subject to the insurer's consent, which shall not be unreasonably withheld. In effect, the defense counsel under these policies becomes a "*Cumis*-type" counsel, as discussed above.

With respect to EPLI insurance, in the author's admittedly biased view, EPLI insurers are for the most part firmly committed to providing this insurance to the marketplace on both a widespread and long-term basis. As such, their interests and those of their insureds in handling the defense should be very much in sync.

It would thus be foolhardy for an EPLI insurer to assign as defense counsel firms or lawyers having no meaningful employment litigation experience but who otherwise do defense work for an insurer at relatively attractive rates. In fact, EPLI insurers have put

60. Perhaps the best discussion of this issue may be found in Federal Ins. Co. v. X-Rite, Inc., 748 F. Supp. 1223 (W.D. Mich. 1990). See *supra* note 4 and accompanying text.

together a fairly impressive "panel" of defense counsel qualified in the employment area and generally at rates significantly higher than those paid for most other insurance defense work. Additionally, there are a number of reasons why an EPLI insurer may be willing to entertain the insured's wishes as to choice of counsel.

Employment-related litigation has unfortunately reached every nook and cranny of this vast nation. It is rather impractical for an insurer to have well-qualified counsel in place for each and every jurisdiction and divisions thereof. Therefore, in certain cases, an insurer may be quite willing (and in fact may have no choice but) to listen to its insured as to selection of counsel if the insured has a local counsel with the appropriate expertise.

Also, insurers are usually open to suggestions as to how they may improve upon their panel of qualified counsel. In particular situations, therefore, an insurer may be willing to "try out" a new counsel recommended by an insured.

In summary, the EPLI insurer may well be able to prevail upon its contractual language in retaining the right to select defense counsel, but the legal, business, and practical considerations discussed above present some very significant limitations on that right.