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Walking a Tightrope: The Tripartite Relationship between Insurer, Insured, and Insurance Defense Counsel

Douglas R. Richmond
Armstrong Teasdale Schlafly & Davis

Douglas R. Richmond*

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I. INTRODUCTION

A standard liability insurance policy provides that the insurer will pay up to coverage limits all sums that the insured becomes legally obligated to pay as damages for injuries to a third party caused by an

* Associate, Armstrong Teasdale Schlafly & Davis, Kansas City, Missouri. B.S., Fort Hays State University; M.Ed., University of Nebraska; J.D., University of Kansas.

"accident" or "occurrence." Policy exclusions expressly limit the insurer's promised coverage.[1] A standard liability insurance policy further obligates the insurer to provide its insured with a defense. Most policies promise that the insurer will defend "any suit against an insured alleging damage within the scope of the policy even if such suit is groundless, false, or fraudulent."[2] Generally, a policy also reserves to the insurer the right to settle, and reserves broad control over the litigation to the company.[3] For these reasons, liability insurance is, essentially, "litigation insurance."[4]

To protect its insured's rights and interests when suit is filed, the insurer hires defense counsel from a panel of firms with which the company regularly deals.[5] The result is the creation of a tripartite relationship between the insurer, the insured, and appointed defense counsel. "The three parties may be viewed as a loose partnership, coalition or alliance directed toward a common goal, sharing a common purpose" during the pendency of the litigation.[6]

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1. Michael J. Brady & Heather A. McKee, *Ethics in Insurance Defense Context: Isn't Cumis Counsel Unnecessary?*, 58 DEF. COUNS. J. 230, 231 (1991). An insurer disputing coverage bears the ultimate burden of proving that the subject loss resulted from a cause falling within a policy exclusion. First Am. Nat'l Bank v. Fidelity & Deposit Co., 5 F.3d 982, 984 (6th Cir. 1993); Chemical Leaman Tank Lines, Inc. v. Aetna Cas. & Sur. Co., 817 F. Supp. 1136, 1143 (D.N.J. 1993); American Star Ins. Co. v. Grice, 854 P.2d 622, 625-26 (Wash. 1993).
2. ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 561 (1987). The existence of a duty to defend initially turns upon those facts known to the insurer at the inception of the litigation. *See* Saylin v. California Ins. Guar. Ass'n, 224 Cal. Rptr. 493, 497 (Ct. App. 1986). The duty to defend arises upon tender of the defense to the insurer. Montrose Chem. Corp. v. Superior Court, 861 P.2d 1153, 1157 (Cal. 1993). As a rule, an insurer's duty to defend is continuing; that is, the insurer's duty continues throughout the course of the litigation against its insured. Lambert v. Commonwealth Land Title Ins. Co., 811 P.2d 737, 739 (Cal. 1991); Home Sav. Ass'n v. Aetna Cas. & Sur. Co., 854 P.2d 851, 855 (Nev. 1993). If it becomes clear in the course of the litigation that no coverage exists under any plausible set of facts, and if the insurer has reserved its rights, or obtained a nonwaiver agreement, the insurer may withdraw its defense provided its withdrawal will not prejudice the insured's interests. An insurer's reservation of rights and the possible effects thereof are discussed in the text accompanying *infra* notes 31-67. An insurer may also be relieved of its duty to defend by a declaratory judgment. *See* New Mexico Physicians Mut. Liab. Co. v. LaMure, 860 P.2d 734, 737 (N.M. 1993). This Article does not address insurers' pursuit of declaratory judgment actions.
3. Thomas V. Murray & Diane M. Bringus, *Insurance Defense Counsel—Conflicts of Interest*, FED'N INS. & CORP. COUNS. Q. 283, 283 (1991).
4. *See* International Paper Co. v. Continental Cas. Co., 320 N.E.2d 619, 621 (N.Y. 1974).
5. Insurance defense counsel are generally selected based on recognized experience and skill in the liability categories the insurer writes. *See* Ronald E. Mallen, *A New Definition of Insurance Defense Counsel*, 53 INS. COUNS. J. 108, 109 (1986).
6. American Mut. Liab. Ins. Co. v. Superior Court, 113 Cal. Rptr. 561, 571 (Ct. App. 1974).

So long as an insurer's interests are harmonious and aligned with those of its insured, there is no inconsistency between the company's duty to defend and its right to control the litigation. But what of the situation where an insurer defends under a reservation of rights? What if a defense attorney's activities generate information supporting a possible coverage defense? What are the parties' respective obligations when plaintiffs' claimed damages exceed coverage? This Article examines conflicts of interest arising out of the unique tripartite relationship characterizing insurance defense.[7] That examination necessarily includes a review of the sources of conflicts, and a look at judicial and legislative actions and reactions. The avoidance and mitigation of potential conflicts of interest are also discussed.

II. AN OVERVIEW OF THE PROBLEM

Conflicts of interest flow not from an insurer's duty to indemnify but, rather, from its duty to defend.[8] Insurers owe their insureds a defense if the allegations of the subject lawsuit are even potentially within the scope of the policy.[9] Generally, whether a defense is owed may be determined by reviewing the petition or complaint.[10] An in-

7. In this context, and as used in this Article, a "[c]onflict of interest between [insured and insurer] occurs whenever their common lawyer's representation of the one is rendered less effective by reason of his representation of the other." Spindle v. Chubb/Pacific Indem. Group, 152 Cal. Rptr. 776, 780-81 (Ct. App. 1979). Some courts have defined conflicts of interest more specifically. *See, e.g.*, Cunniff v. Westfield, Inc., 829 F. Supp. 55 (E.D.N.Y. 1993). The *Cunniff* court observed that, under New York law, a conflict requiring independent counsel arises when " '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 render the insurer liable.' " *Id.* at 57 (quoting Public Serv. Mut. Ins. Co. v. Goldfarb, 425 N.E.2d 810, 815 n.* (N.Y. 1981)).

8. Sharon K. Hall, Note, *Confusion Over Conflicts of Interest: Is There a Bright Line for Insurance Defense Counsel?*, 41 DRAKE L. REV. 731, 732 (1992).

9. Enserch Corp. v. Shand Morahan & Co., 952 F.2d 1485, 1492 (5th Cir. 1992)(applying Texas law); Tews Funeral Home, Inc. v. Ohio Cas. Ins. Co., 832 F.2d 1037, 1042 (7th Cir. 1987)(applying Illinois law); E.B. & A.C. Whiting Co. v. Hartford Fire Ins. Co., 838 F. Supp. 863, 866-67 (D. Vt. 1993); Harleysville Mut. Ins. Co. v. Sussex County, 831 F. Supp. 1111, 1130 (D. Del. 1993)(applying New Jersey law); Kootenai County v. Western Cas. & Sur. Co., 750 P.2d 87, 89 (Idaho 1988); James Graham Brown Found., Inc. v. St. Paul Fire & Marine Ins. Co., 814 S.W.2d 273, 279 (Ky. 1991); Mutual Serv. Cas. Ins. Co. v. Luetmer, 474 N.W.2d 365, 368 (Minn. Ct. App. 1991); Biborosch v. Transamerica Ins. Co., 603 A.2d 1050, 1052 (Pa. Super. Ct.), *appeal denied*, 615 A.2d 1310 (Pa. 1992).

10. *See* Lime Tree Village Community Club Ass'n, Inc. v. State Farm Gen. Ins. Co., 980 F.2d 1402, 1405 (11th Cir. 1993)(looking at allegations in complaint to determine duty to defend under Florida law); Selective Ins. Co. v. J.B. Mouton & Sons, Inc., 954 F.2d 1075, 1077 (5th Cir. 1992)(comparing allegations in complaint with policy terms to determine duty to defend under Louisiana law); St. Paul Fire & Marine Ins. Co. v. Vigilant Ins. Co., 919 F.2d 235, 239 (4th Cir. 1990)(applying North Carolina law); First Nat'l Bank & Trust Co. v. St. Paul Fire & Marine Ins.

surer must defend a claim against its insured "when any theory of the complaint gives rise to the possibility that the insurer would be liable for its costs."[11] The petition or complaint must be liberally interpreted for purposes of determining whether coverage is excluded.[12] If just one of several pleaded theories potentially triggers coverage, the insurer is obligated to defend the entire suit, even if other bases for recovery are specifically excluded under the policy.[13]

The duty to defend is broad, and in some jurisdictions its determination may require more than a simple review of pleadings:

> [The insurer] must look beyond the effect of the pleadings and consider any facts brought to its attention or any facts which it could reasonably discover when determining whether it has a duty to defend . . . . The possibility of coverage may be remote, but if it exists the company owes the insured a defense. The possibility of coverage must be determined by a good faith analysis of all information known to the insured or all information reasonably ascertainable by inquiry and investigation.[14]

Co., 770 F. Supp. 513, 515 (D.N.D. 1991), *aff'd*, 971 F.2d 142 (8th Cir. 1992); Apcon Corp. v. Dana Trucking, Inc., 623 N.E.2d 806, 809 (Ill. App. Ct. 1993), *appeal denied*, 631 N.E.2d 705 (Ill. 1994); Continental Cas. Co. v. Gilbane Bldg. Co., 461 N.E.2d 209, 212 (Mass. 1984)(observing that duty to defend is decided by matching complaint with policy provisions); State Farm Fire & Cas. Co. v. Paget, 860 P.2d 864, 866 (Or. Ct. App. 1993); Capital Bank v. Commonwealth Land Title Ins. Co., 861 S.W.2d 84, 87 (Tex. Ct. App. 1993)(looking at policy language and allegations of complaint to determine duty to defend); Professional Office Bldgs., Inc. v. Royal Indem. Co., 427 N.W.2d 427, 430 (Wis. Ct. App. 1988); First Wyoming Bank, N.A. v. Continental Ins. Co., 860 P.2d 1094, 1097 (Wyo. 1993).

11. Illinois Mun. League Risk Mgt. Ass'n v. Seibert, 585 N.E.2d 1130, 1134 (Ill. App. Ct. 1992). *Cf.* Gerrity Co. v. CIGNA Prop. & Cas. Ins. Co., 860 P.2d 606, 607 (Colo. Ct. App. 1993)(looking to complaint's factual allegations, and not legal claims, to determine insurer's duty to defend).

12. *In re* Complaint of Stone Petroleum Corp., 961 F.2d 90, 91 (5th Cir. 1992).

13. Gregory v. Tennessee Gas Pipeline Co., 948 F.2d 203, 205 (5th Cir. 1991)(applying Louisiana law); Tews Funeral Home Inc. v. Ohio Cas. Ins. Co., 832 F.2d 1037, 1042 (1987); Overthrust Constructors, Inc. v. Home Ins. Co., 676 F. Supp. 1086, 1091 (D. Utah 1987)(applying Utah law); LaJolla Beach & Tennis Club, Inc. v. Industrial Indem. Co., 23 Cal. Rptr. 2d 656, 659 (Ct. App. 1993), *cert. granted*, 866 P.2d 1311 (Cal. Jan. 27, 1994)(No. S036170)(quoting Devin v. United Servs. Auto. Ass'n, 8 Cal. Rptr. 2d 263, 273 (Ct. App. 1992)); Voorhees v. Preferred Mut. Ins. Co., 607 A.2d 1255, 1259 (N.J. 1992).

14. Patron's Mut. Ins. Ass'n v. Harmon, 732 P.2d 741, 744 (Kan. 1987). *See* Aetna Cas. & Sur. Co. v. Dannenfeldt, 778 F. Supp. 484, 499 (D. Ariz. 1991); American Motorists Ins. Co. v. Allied-Sysco Food Servs., Inc., 24 Cal. Rptr. 2d 106, 112 (Ct. App. 1993)("The existence of a potential for liability is determined from the facts learned by the insurer, either as pleaded in the complaint or from extrinsic sources."); Spivey v. Safeco Ins. Co., 865 P.2d 182, 188 (Kan. 1993)("[A]n insurer must look beyond the effect of the pleadings and must consider any facts brought to its attention or any facts which it could reasonably discover in determining whether it has a duty to defend."); SL Indus., Inc. v. American Motorists Ins. Co., 607 A.2d 1266, 1272 (N.J. 1992)(stating that facts outside complaint may trigger duty to defend if known to insurer); Fitzpatrick v. American Honda Motor Co., 575 N.E.2d 90, 93 (N.Y. 1991).

Any doubts about coverage must be resolved in the insured's favor.[15] An insurer that breaches its duty to defend is bound by a settlement or judgment rendered against its insured.[16]

Because of its financial interest in the effective resolution of a claim, the insurer has a contractual right to control its insured's defense.[17] The right to control the defense of litigation is part of the insurer's business, and it is certainly one of the services an insured bargains for when purchasing liability insurance.[18] Policy provisions giving an insurer the right to control the defense of litigation amount to an insured's advance consent to the insurer's employment of its chosen defense attorney.[19] By retaining the ability to select counsel of their choice, insurers are better able to economically and effectively defend claims,[20] participate in strategic decisions, and seize settlement opportunities.[21]

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15. Lime Tree Village Community Club Ass'n, Inc. v. State Farm Gen. Ins. Co., 980 F.2d 1402, 1405 (11th Cir. 1993); Harrow Prods., Inc. v. Liberty Mut. Ins. Co., 833 F. Supp. 1239, 1248 (W.D. Mich. 1993); Nationwide Mut. Ins. Co. v. Worthey, 861 S.W.2d 307, 310 (Ark. 1993); Horace Mann Ins. Co. v. Barbara B., 846 P.2d 792, 796 (Cal. 1993); Biborosch v. Transamerica Ins. Co., 603 A.2d 1050, 1052 (Pa. Super. Ct.), *appeal denied*, 615 A.2d 1310 (Pa. 1992); Elliott v. Donahue, 485 N.W.2d 403, 407 (Wis. 1992). *See also* S.G. v. St. Paul Fire & Marine Ins. Co., 460 N.W.2d 639, 642 (Minn. Ct. App. 1990)(stating that when construing insurance contract, all doubts must be resolved in the insured's favor); American Economy Ins. Co. v. Hughes, 854 P.2d 500, 501 (Or. Ct. App. 1993)(construing exclusions narrowly).
16. *See* MIC Prop. & Cas. Ins. Corp. v. International Ins. Co., 990 F.2d 573, 576-77 (10th Cir. 1993)(applying Oklahoma law); Columbia Mut. Ins. Co. v. Fiesta Mart, Inc., 987 F.2d 1124, 1127 (5th Cir. 1993)(applying Texas law); Manzanita Park, Inc. v. Insurance Co. of N. Am., 857 F.2d 549, 553 (9th Cir. 1988)(discussing Arizona law and collateral estoppel); Hyatt Corp. v. Occidential Fire & Cas. Co., 801 S.W.2d 382, 388-89 (Mo. Ct. App. 1990); Ames v. Continental Cas. Co., 340 S.E.2d 479, 485 (N.C. Ct. App. 1986).
17. *See* Illinois Masonic Med. Ctr. v. Turegum Ins. Co., 522 N.E.2d 611, 613 (Ill. App. Ct. 1988); Parker v. Agricultural Ins. Co., 440 N.Y.S.2d 964, 967 (Sup. Ct. 1981)("The purpose of such right is to allow insurers to protect their financial interest in the outcome of litigation . . . ."). *See also* Aberle v. Karn, 316 N.W.2d 779, 782 (N.D. 1982)(insurers' right to control defense "justified by a substantial public interest in orderly and proper disposition" of claims).
18. Montrose Chem. Corp. v. Superior Court, 861 P.2d 1153, 1157 (Cal. 1993)("The insured's desire to secure . . . the insurer's . . . defense of third party claims is, in all likelihood, typically as significant a motive for the purchase of insurance as is the wish to obtain indemnity for possible liability."); Houston Gen. Ins. Co. v. Superior Court, 166 Cal. Rptr. 904, 910 (Ct. App. 1980)(Smith, A.J., dissenting).
19. Brady & McKee, *supra* note 1, at 231.
20. Insurers are usually best able to select competent defense counsel with whom they have negotiated favorable hourly rates.
21. "Insureds share their insurers' interest in reducing total claims costs. Without prudent claims administration, insurance might be unaffordable . . . . Inevitably, increased costs of insurers result in increased costs to insureds." John K. Morris, *Conflicts of Interest in Defending Under Liability Insurance Policies: A Proposed Solution*, 1981 UTAH L. REV. 457, 460.

The tripartite relationship between insurer, insured, and insurance defense counsel is unique.[22] In no other area of the law are parties routinely represented by counsel selected and paid by a third party whose interests may differ from those of the individual or entity the attorney was hired to defend.[23] The potential for conflict is inherent in the tripartite relationship. The source of most conflicts of interest, both actual and perceived, is the "dual client doctrine." The dual client doctrine reflects a widespread recognition that insurance defense counsel are deemed to have two clients in any given case: the insurer and the insured.[24]

The problems posed by the dual client doctrine rest on the premise that insurance defense counsel cannot loyally represent the insured in any situation posing an actual or potential conflict of interest with the insurer.[25] Insurance defense counsel are generally specialists doing a substantial volume of business with several carriers.[26] The close economic and personal relationships that develop between defense attorneys and insurers arguably can lead to a reduced emphasis on insureds' interests in particular cases.[27] This problem is exacerbated by the fact that while a defense attorney generally has an on-going

22. Bruce L. Gelman, Note, *The Insurance Company or the Insured: Where Does Defense Counsel's Loyalty Really Lie?*, 70 U. DET. MERCY L. REV. 215, 215 (1992).
23. *See id.* at 215.
24. Robert E. O'Malley, *Ethics Principles for the Insurer, the Insured and Defense Counsel: The Eternal Triangle Reformed*, 66 TULANE L. REV. 511, 511 (1991). The existence of an attorney-client relationship between an insurer and the attorney it hires to defend its insured has been recognized by numerous courts. *See, e.g.*, Central Nat'l Ins. Co. v. Medical Protective Co., 107 F.R.D. 393, 394-95 (E.D. Mo. 1985); Mitchum v. Hudgens, 533 So. 2d 194, 198 (Ala. 1988); Chi of Alaska, Inc. v. Employers Reins. Corp., 844 P.2d 1113, 1116 (Alaska 1993); Bogard v. Employers Cas. Co., 210 Cal. Rptr. 578, 582 (Ct. App. 1985); Pennsylvania Ins. Guar. Ass'n v. Sikes, 590 S.2d 1051, 1052 (Fla. Dist. Ct. App. 1991); Nandorf v. CNA Ins. Cos., 479 N.E.2d 988, 991 (Ill. App. Ct. 1985); Hartford Accident & Indem. Co. v. Foster, 528 So. 2d 255, 268 (Miss. 1988); Lieberman v. Employers Ins., 419 A.2d 417, 423-25 (N.J. 1980). *But see* Continental Cas. Co. v. Pullman, Comley, Bradley & Reeves, 929 F.2d 103, 108 (2d Cir. 1991)("It is clear beyond cavil that . . . the attorney owes his allegiance not to the insurance company that retained him, but to the insured. . . ."); *In re* A.H. Robins Co., 880 F.2d 694, 751 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989)("It is universally declared that [insurance defense] counsel represents the insured and not the insurer."); National Union Fire Ins. Co. v. Stites Prof. Law Corp., 1 Cal. Rptr. 2d 570, 575 (Ct. App. 1991)(insurer had no contractual right to actually control defense, so it had no attorney-client relationship with defense counsel); Atlanta Int'l Ins. Co. v Bell, 475 N.W.2d 294, 297-99 (Mich. 1991)(no attorney-client relationship between insurer and defense counsel). For a confused analysis of the dual client doctrine in connection with claims of privilege, see Catino v. Travelers Ins. Co., 136 F.R.D. 534, 537 (D. Mass. 1991).
25. *See* O'Malley, *supra* note 24, at 514.
26. Morris, *supra* note 21, at 463.
27. As the Eighth Circuit Court of Appeals observed in United States Fidelity & Guaranty Co. v. Louis A. Roser Co., 585 F.2d 932 (8th Cir. 1978):

relationship with an insurer—fueled by a desire for future business—the attorney's relationship with the insured is usually limited to the defense of a single case.

The dual client doctrine spawns numerous costly and time-consuming distractions for insurers, insureds, and attorneys.[28] As explained by the Vice Chairman and Loss Prevention Counsel of the Attorneys' Liability Assurance Society, Inc. ("ALAS"), one of the largest and most sophisticated legal malpractice insurers:

> These distractions include: 1) Insureds not being candid with defense counsel; 2) Defense counsel must at all times be alert to potential conflicts between insured and insurer; 3) Significant conflicts must be disclosed to and discussed with the insured and the insurer; 4) If a conflict develops, defense counsel must obtain consent of both "clients" in order to proceed; 5) An analysis must be made as to whether a given conflict of interest is so serious as to be nonconsentable; 6) If the conflict is nonconsentable, defense counsel must resign; 7) If the insured is entitled to separate counsel in place of, or in addition to, the original appointed defense counsel, who is responsible for that expense?; 8) In any event, if separate or independent counsel represents the insured, who controls the defense?; 9) In view of the "joint confidences" or "co-client" doctrine (i.e., there is no attorney-client privilege or obligation of confidentiality between and among two or more clients—the insured and the insurer—and their common lawyer, defense counsel), is defense counsel obligated or permitted to disclose to one of the clients information that is unfavorable to the other?; and 10) Defense counsel is, at all times, concerned about potential malpractice liability.[29]

When the usually harmonious tripartite relationship is disrupted by the appearance of a conflict of interest between insurer and insured, defense counsel are left to walk an ethical tightrope. A defense attorney's misstep can result in malpractice liability, discipline for a breach of ethics rules, a loss of coverage defenses for the insurer, or some unpleasant combination of the three.[30]

> Even the most optimistic view of human nature requires us to realize that an attorney employed by an insurance company will slant his efforts, perhaps unconsciously, in the interests of his real client—the one who is paying his fee and from whom he hopes to receive future business—the insurance company.

Id. at 938 n.5. *See also* Rose v. Royal Ins. Co., 3 Cal. Rptr. 2d 483, 487 (Ct. App. 1991)("Where an insurer is called upon to defend its insured, the attorney retained by the insurer may have a compelling interest in perfecting the insurer's position, whether or not it coincides with what is best for the insured.").

In most cases this concern is unfounded. As a rule, the insurer and its insured share a common interest in minimizing or defeating a third-party claim. *See* San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc., 208 Cal. Rptr. 494, 498 (Ct. App. 1984); Allstate Ins. Co. v. Campbell, 639 A.2d 652, 658 (Md. 1994).

28. *See* O'Malley, *supra* note 24, at 515.

29. *See id.* at 515-16.

30. *See* Debra A. Winiarski, *Walking the Fine Line: A Defense Counsel's Perspective*, 28 TORT & INS. L.J. 596, 597 (1993).

III. CONFLICTS OF INTEREST

The tripartite relationship between insurer, insured, and defense counsel makes potential conflicts of interest inevitable. Insureds are threatened by conflicts because of the effect on their defense. Conflicts of interest may strip insurers of coverage defenses and expose them to the threat of extracontractual damages. From defense counsel's perspective, with potential conflicts of interest come potential malpractice claims. The fundamental malpractice danger posed by conflicts of interest is that the insured (the client) will allege that defense counsel protected the insurer's interest at the insured's expense, and to the insured's ultimate detriment. What follows is an examination of the most common potential conflicts of interest attributable to the tripartite relationship.

A. Reservation of Rights

An insurer often undertakes its insured's defense with coverage questions unanswered, or with coverage issues unresolved. Under such circumstances, the possibility exists that the insured will contend that by assuming the defense, the insurer is estopped to deny coverage, or has waived its right to contest coverage.[31] To foreclose estoppel or waiver arguments, insurers routinely send reservation of rights letters via certified mail. A reservation of rights letter is an insurer's unilateral declaration that it reserves the right to deny coverage, despite its initial decision to defend. One purpose of a reservation of rights letter is to enable the insured to make intelligent decisions relative to protecting the insured's own interests in the face of possible coverage denials and conflicts of interest. The insurer must therefore specifically reference the policy defenses which may ultimately be asserted, and inform the insured of the potential conflict of interest its reservation creates.[32] Reservation of rights letters which are not specific are usually ineffective. A reservation of rights letter does not evidence an insured's consent to the insurer's conditional representation.[33]

An insurer's reservation of rights presents a classic conflict of interest. There always exists the possibility that a liability insurer which reserves its rights has a diminished interest in its insured's de-

31. *See* JERRY, *supra* note 2, at 605.

32. *See* Royal Ins. Co. v. Process Design Assocs., 582 N.E.2d 1234, 1239 (Ill. App. Ct. 1991). *See also* Ideal Mut. Ins. Co. v. Myers, 789 F.2d 1196, 1197-1201 (5th Cir. 1986)(discussing effective reservation of rights letter); Knox-Tenn Rental Co. v. Home Ins. Co., 833 F. Supp. 665, 667-69 (E.D. Tenn. 1992), *aff'd*, 2 F.3d 678 (6th Cir. 1993)(holding reservation of rights was not clearly and fairly communicated to insured, and was therefore ineffective).

33. *See* JERRY, *supra* note 2, at 606.

fense, since it might later prevail on the coverage issue.[34] Defense counsel can often steer a case toward a coverage result favorable to the insurer. For example, a defense attorney may elicit deposition testimony supporting a coverage defense. If these arguments are credited, a conflict can be avoided only if (1) appointed defense counsel withdraws, or (2) the insured is allowed to select his own independent counsel at the insurer's expense. It is the latter solution that has caused innumerable problems for the insurance industry.

In 1984, a California appellate court stunned the industry when it suggested that an insurer's reservation of rights always poses a conflict of interest, potentially requiring the insured's engagement of independent counsel at the insurer's expense. In *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*,[35] the plaintiff sued several of the defendant's insureds on a variety of contract and tort theories, seeking $750,000 in compensatory damages and $6,500,000 in punitives.[36] The insurer's associate counsel, Willis McAllister, hired the firm of Goebel & Monaghan to represent Cumis' insureds, simultaneously telling the firm that the carrier was reserving its right to later deny coverage, and that its policies did not cover punitive damages. McAllister never asked Goebel & Monaghan for a coverage opinion, and the firm offered no coverage advice to Cumis or its insureds. McAllister wrote each of Cumis' insureds, reserving the company's right to disclaim coverage and denying any coverage for punitive damages.[37]

The Credit Union hired the firm of Saxon, Alt & Brewer ("Saxon") as co-counsel to protect the defendants' interests. Saxon presented Cumis with two invoices for fees and costs, which McAllister was persuaded to pay.[38] McAllister declined to pay further Saxon invoices, having conferred with his home office and with Goebel & Monaghan, all concluding that there was no conflict of interest.[39] At a later settlement conference, the plaintiff offered to settle within policy limits. Cumis authorized Goebel & Monaghan to make a settlement offer at

34. "A reservation of rights may chill a zealous defense based on the insurer's assessment of the liability and it presents a possible conflict of interest because the insurer may be more concerned with developing facts showing non-coverage than facts defeating liability." Missouri *ex rel.* Rimco, Inc. v. Dowd, 858 S.W.2d 307, 308 (Mo. Ct. App. 1993). *See also* Rockwell Int'l Corp. v. Superior Court, 32 Cal. Rptr. 2d 153, 158 (Ct. App. 1994) (observing that the insured's goal of coverage flies in the face of the insurer's desire to avoid its duty to indemnify under a reservation of rights).

35. 208 Cal. Rptr. 494 (Ct. App. 1984).

36. The plaintiff alleged wrongful discharge, breach of the covenant of good faith and fair dealing, wrongful interference with and inducing breach of contract, breach of contract, and intentional infliction of emotional distress. *Id.* at 496.

37. *Id.*

38. *Id.* at 497.

39. *Id.*

the conference, but below the plaintiff's demand. Goebel & Monaghan did not communicate with the Credit Union before or during the settlement conference, instead informing the Credit Union about the conference afterward.[40] The trial court concluded that Cumis was obligated to pay the Credit Union's past and future expenses related to Saxon's engagement.

On appeal, Cumis argued that it could not be required to pay for its insured's independent counsel. The *Cumis* appellate court affirmed the trial court, stating:

> We conclude . . . lawyers hired by [an] insurer [have] an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage. If the insured does not give an informed consent to continued representation, counsel must cease to represent both. Moreover, in the absence of such consent, where there are divergent interests of the insured and the insurer brought about by the insurer's reservation of rights based on possible noncoverage under the insurance policy, the insurer must pay the reasonable cost for hiring independent counsel by the insured. The insurer may not compel the insured to surrender control of the litigation . . . .[41]

Although both the insurer and insured shared a common interest in winning the third-party action, their remaining interests were so divergent "as to create an actual, ethical conflict of interest" warranting independent counsel.[42]

The court in *Cumis* reasoned that the insurer's desire to establish in the third-party suit that the insured's liability rested on intentional conduct (thus being excluded from coverage) and the insured's desire to base liability on its negligent conduct (thereby triggering coverage) represented opposing poles of interest.[43] While recognizing that coverage issues would not be actually litigated in the third-party action, the court believed that this would not spare appointed insurance defense counsel from the force of these opposing interests, given the dual representation.[44] The appellate court accepted the trial court's reasoning that the carrier was required to pay for independent counsel because defense counsel would be tempted to develop the facts to help his real client, the insurer, as opposed to the insured, for whom he would likely never work again.[45] Given the close-knit nature of insurance defense practice, a defense attorney who did not first protect an insurer's interest might well lose business.[46]

Cumis led to the widespread use of so-called "*Cumis* counsel." Insureds who found themselves being defended under a reservation of

40. *Id.*
41. *Id.* at 506 (citations omitted).
42. *Id.*
43. *Id.* at 498.
44. *Id.*
45. *Id.* at 497-98.
46. *See id.* at 498.

rights in California almost always engaged independent counsel. *Cumis* had "extremely adverse economic consequences" in California and other states following California's lead, driving up litigation costs.[47] The *Cumis* economic burden was the product of several elements. First, unscrupulous attorneys were able to masquerade as necessary *Cumis* counsel by manufacturing phony conflicts of interest, thereby defrauding insurers.[48] Second, *Cumis* counsel are often able to charge insurers fees well in excess of those insurers negotiate with their regular panel counsel. Finally, independent counsel often lack the experience and skill of the insurer's regular counsel.[49] As a result, pretrial matters may be handled less efficiently and the probability of a favorable outcome reduced.[50]

California narrowed the broad holding of *Cumis* through a series of subsequent decisions.[51] Not every reservation of rights creates a conflict of interest requiring the engagement of independent counsel.[52] The necessity of independent counsel now depends on the nature of the coverage question as it relates to the underlying case. *Cumis* counsel is not required if the issue on which coverage hinges is in-

47. Brady & McKee, *supra* note 1, at 232-33.

48. For example, a group of California attorneys known as "The Alliance" may have defrauded insurers out of as much as $200,000,000 by exploiting bogus conflicts of interest. *Id.* at 233.

49. *Id.*

50. These problems may be resolved by holding the insured to a duty of good faith and fair dealing. As the California Court of Appeal observed:

> In our view, the duty of good faith imposed upon an insured includes the obligation to act reasonably in selecting as independent 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. Conduct arguably acceptable in the ordinary attorney-client relationship where the latter pays the former from his own pocket is not necessarily appropriate in the tripartite context when independent counsel undertakes to represent the insured at the expense of the insurer.

Center Found. v. Chicago Ins. Co., 278 Cal. Rptr. 13, 21 (Ct. App. 1991). The Alaska Supreme Court held in Chi of Alaska v. Employers Reinsurance Corp., 844 P.2d 1113 (Alaska 1993), that the insurer was obligated to pay only the "reasonable cost of defense" provided by independent counsel. *Id.* at 1121. While the insured had a unilateral right to select independent counsel, it also had a duty to "select an attorney who is, by experience and training, reasonably thought to be competent to conduct the defense . . . ." *Id.* at 1125. The *Chi of Alaska* court believed that this approach balanced both parties' interests.

51. *See, e.g.*, Foremost Ins. Co. v. Wilks, 253 Cal. Rptr. 596, 601-603 (Ct. App. 1988)(concluding mere punitive damage claim does not create conflict of interest); Native Sun Inv. Group v. Ticor Title Ins. Co., 235 Cal. Rptr. 34, 39-40 (Ct. App. 1987)(resolution of underlying case would not control outcome of coverage dispute; thus, *Cumis* counsel not required); McGee v. Superior Court, 221 Cal. Rptr. 421, 424 (Ct. App. 1985)(reservation of rights based on a collateral issue that would not be developed at trial, so independent counsel not required).

52. Blanchard v. State Farm Fire & Cas. Co., 2 Cal. Rptr. 2d 884, 887 (Ct. App. 1991).

dependent of the issues in the third-party action. As explained by the court in *Blanchard v. State Farm Fire and Casualty Co.*,[53] "[a] conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel first retained by the insurer for the defense of the underlying claim."[54]

Not all courts accepted the *Cumis* view that appointed counsel cannot be trusted to serve the interests of those they are hired to defend. In *Siebert Oxidermo, Inc. v. Shields*,[55] an Indiana court flatly rejected an insured's argument that its appointed counsel had an economic interest in failure, thus supporting the insurer's coverage defense.

> We consider the argument impertinent, if not scandalous. Without considering the respected reputation of the attorney involved, we point out that on a daily basis defense attorneys employed by insurance carriers . . . are called upon to deal with matters in litigation where the interests of the policyholder and the carrier do not fully coincide. Under such circumstances the attorney's duty is, of course, to the insured whom he has been employed to represent. In response the defense bar has exhibited no inability to fully comply with both the letter and spirit of . . . the Code of Professional Responsibility. If it were otherwise, we suspect the desirability of requiring carriers to supply defense counsel would have long since disappeared as a term of the policy.[56]

The Supreme Court of Missouri faced a slightly different conflict in *In re Allstate Insurance Co.*[57] Allstate employed full-time salaried attorneys to defend cases in which coverage was uncontested and claimed damages fell within policy limits. The informants argued that a liability insurer could not assign its own in-house attorneys to defend its insureds without creating conflicts of interest.[58] Noting that both in-house and appointed counsel were bound by ethics rules requiring withdrawal if a conflict appeared, the court in *Allstate* disagreed. The court reasoned that there was "no basis for a conclusion that employed lawyers have less regard for the Rules of Professional Conduct than private practitioners do."[59]

One way to resolve the conflict posed by a defense under a reservation of rights is to impose an "enhanced" duty of good faith on the reserving insurer.[60] This approach was first taken by the Washington

53. *Id.*
54. *Id.* at 887. *See also* Northern Ins. Co. v. Allied Mut. Ins. Co., 955 F.2d 1353, 1359 (9th Cir. 1992)(applying California law).
55. 430 N.E.2d 401 (Ind. Ct. App. 1982), *aff'd*, 446 N.E.2d 332 (Ind. 1983).
56. *Id.* at 403.
57. 722 S.W.2d 947 (Mo. 1987).
58. *See id.* at 951.
59. *Id.* at 953.
60. "A duty to act in good faith is part of every insurance contract." Kansas Bankers Sur. Co. v. Lynass, 920 F.2d 546, 548 (8th Cir. 1990). It is widely-recognized that insurers owe their insureds a duty of good faith and fair dealing sounding in tort. *See, e.g.*, Lissmann v. Hartford Fire Ins. Co., 848 F.2d 50, 53 (4th Cir. 1988); Hamed v. General Accident Ins. Co., 842 F.2d 170, 172 (7th Cir. 1988); Broadhead v. Hartford Cas. Ins. Co., 773 F. Supp. 882, 905 (S.D. Miss. 1991),

Supreme Court in *Tank v. State Farm Fire & Casualty Co.*[61] The *Tank* court explained:

> We have stated that the duty of good faith of an insurer requires fair dealing and equal consideration for the insured's interests.... [T]he same standard of fair dealing and equal consideration is unquestionably applicable to a reservation-of-rights defense. We find, however, that the potential conflicts of interest between insurer and insured inherent in this type of defense mandate an even higher standard: an insurance company must fulfill an enhanced obligation to its insured as part of its duty of good faith.[62]

Insurers can meet *Tank's* enhanced obligation of good faith by (1) thoroughly investigating the plaintiff's claim; (2) retaining competent defense counsel who, like the insurer, must understand that the insured is the sole client; (3) fully informing the insured of all coverage questions or issues and related developments, and of the progress of the lawsuit; and (4) refraining from any action that demonstrates a greater concern for the insurer's monetary interests than for the insured's financial risk.[63] Failure to satisfy this enhanced obligation may expose the insurer and defense counsel to liability.[64]

In *L & S Roofing Supply Co. v. St. Paul Fire & Marine Insurance Co.*,[65] the Alabama Supreme Court followed the reasoning of the court in *Tank*. In *L & S Roofing*, the court concluded that the *Tank* standard and specified criteria provided an adequate means for safeguarding insureds' interests without questioning the integrity or loyalty of insurance defense counsel.[66]

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aff'd, 979 F.2d 209 (5th Cir. 1992); Turner Ins. Agency v. Continental Cas. Ins. Co., 541 So. 2d 471, 472 (Ala. 1989); Rawlings v. Apodaca, 726 P.2d 565, 571-72 (Ariz. 1986); Globe Indem. Co. v. Superior Court, 8 Cal. Rptr. 2d 251, 255 (Ct. App. 1992); Southern Gen. Ins. Co. v. Holt, 416 S.E.2d 274, 276 (Ga. 1992); White v. Unigard Mut. Ins. Co., 730 P.2d 1014, 1016 (Idaho 1986); Erie Ins. Co. v. Hickman, 622 N.E.2d 515, 518-19 (Ind. 1993); North Iowa State Bank v. Allied Mut. Ins. Co., 471 N.W.2d 824, 828-29 (Iowa 1991); Ganaway v. Shelter Mut. Ins. Co., 795 S.W.2d 554, 556 (Mo. Ct. App. 1990); Braesch v. Union Ins. Co., 237 Neb. 44, 48-49, 464 N.W.2d 769, 772 (1991); Motorists Mut. Ins. Co. v. Said, 590 N.E.2d 1228, 1232 (Ohio 1992); Townsend v. State Farm Mut. Auto. Ins. Co., 860 P.2d 236, 237-38 (Okla. 1993); Georgetown Realty, Inc. v. Home Ins. Co., 831 P.2d 7 (Or. 1992); Nichols v. State Farm Mut. Auto. Ins. Co., 306 S.E.2d 616, 618-19 (S.C. 1983); Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987); McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 858 (Wyo. 1990). Plaintiffs may recover for an insurer's bad faith even when the event giving rise to a loss is not covered by the policy. *See, e.g.*, First Tex. Sav. Ass'n v. Reliance Ins. Co., 950 F.2d 1171, 1178-79 (5th Cir. 1992)(interpreting Texas unfair insurance practices statute); Safeco Ins. Co. v. Butler, 823 P.2d 499 (Wash. 1992).

61. 715 P.2d 1133 (Wash. 1986).

62. *Id.* at 1137.

63. *See id.*

64. *Id.*

65. 521 So. 2d 1298 (Ala. 1987).

66. *See id.* at 1304.

Ultimately, how potential conflicts of interest should be resolved when an insurer reserves its rights is a matter of perspective.[67] Those who trust appointed counsel to afford insureds undivided loyalty, and to vigorously defend them, see no conflict in a reservation of rights defense. On the other hand, those who presume insurance defense attorneys will inevitably be influenced by the insurers with whom they have business relationships view the broad right to independent counsel once granted by *Cumis* as the only viable solution.

B. Claimed Damages Exceed Coverage

Cases in which claimed damages exceed coverage provide the potential for conflicts. The situation is especially serious if defense counsel believes that the jury verdict, and not just the amount stated in an *ad damnum* clause or prayer for relief, may exceed coverage. Conflicts arise when solid potential liability defenses exist, but defense counsel knows that the case can be settled within policy limits. One conflict, of course, stems from the insured's entitlement to defense counsel who will advance only the insured's interests in such a situation.[68] At the same time, the insurer has a powerful economic incentive to litigate aggressively in the hope of obtaining a low verdict. This situation poses genuine practical problems for defense counsel; after all, insurers do not hire them simply to give away money. Woe be it to defense counsel who are unwilling to try tough cases.

The attorney assigned a case with a potential excess judgment must at a minimum inform both the insured and insurer of any settlement offer so that they may take steps necessary to protect their interests. At least one court has suggested that counsel do nothing more than inform both parties. The court in *Hartford Accident & Indemnity Co. v. Foster*[69] cautioned that the defense attorney should limit his role to responding to "questions pertaining to the law and facts of the case."[70] Defense counsel should be careful not to violate the "absolute, nondelegable responsibility not to urge, recommend or suggest any course of action to the carrier which violates his conflict of interest obligation."[71]

A defense attorney who fails to settle a case within policy limits despite the opportunity to do so may be personally liable for any ex-

67. *See* JERRY, *supra* note 2, at 607.

68. *See* Parsons v. Continental Nat'l Am. Group, 550 P.2d 94, 98 (Ariz. 1976)(defense counsel owes insured undeviating and single allegiance); Purdy v. Pacific Auto. Ins. Co., 203 Cal. Rptr. 524, 533 (Ct. App. 1984)(defense counsel's primary duty is to further the insured's best interests).

69. 528 So. 2d 255 (Miss. 1988).

70. *Id.* at 273.

71. *Id.*

cess judgment. In *Mutuelles Unies v. Kroll & Linstrom*,[72] a defense firm was slapped with a $2,183,381 malpractice verdict when the plaintiff in the underlying action demanded $1,000,000 to settle, but trial counsel refused to offer more than $900,000.[73] The malpractice victor was the liability insurer, which recovered the difference between the plaintiffs' lowest settlement figure and the jury verdict in the third-party action.

C. Defense Costs Reduce Available Coverage

Liability coverage is sometimes provided under what is known variably as a "defense within limits," "wasting," or "ultimate net loss" policy. These insurance policies provide that defense costs, such as attorneys' fees, are paid out of policy limits. In other words, defense costs erode or reduce available coverage. An insured is potentially prejudiced every time her appointed counsel acts, since every dollar the attorney earns in fees reduces the available coverage. In such cases, insureds must always be timely informed of defense expenditures and the amount of remaining coverage.

D. Representation of Multiple Parties

As is generally true, the representation of multiple parties presents serious potential conflicts. Two or more insureds may have adverse interests. This is particularly true in automobile liability cases, in which a passenger frequently sues both the driver and the owner.[74] It may be in the driver's best interests to be viewed as the owner's agent, while the owner's interest might be best served by arguing that the driver was operating the vehicle without permission.[75] Under such circumstances, independent counsel paid by the insurer is required.[76] The same situation sometimes arises in products liability actions in which multiple manufacturers or distributors may be insured by the same carrier. For example, the manufacturer of a piece of industrial equipment and the manufacturer of a component part in that machine both may have the same insurer. Because the machine manufacturer may allege that the component part was defective, and might thus allege its manufacturer's comparative fault, the parties' interests are necessarily adverse.

An unusual situation involving multiple parties was litigated in *State Farm Mutual Automobile Insurance Co. v. Armstrong Extin-*

72. 957 F.2d 707 (9th Cir. 1992).
73. *See id.* at 710-11.
74. *See, e.g.*, Murphy v. Urso, 430 N.E.2d 1079 (Ill. 1981).
75. *See id.* at 1083-84.
76. *See* Illinois Mun. League Risk Mgt. Ass'n v. Seibert, 585 N.E.2d 1130, 1136 (Ill. App. Ct. 1992).

guisher Service, Inc.[77] The defendant and third-party plaintiff in the underlying state court action sued Armstrong and its employee, Michael Larson, alleging Larson's contributory fault and Armstrong's vicarious liability in connection with an automobile accident. Larson was one of the drivers involved in the crash. Armstrong's insurer hired one of its regular defense attorneys, Curt Ireland, to represent both Armstrong and Larson; however, State Farm defended under a reservation of rights.[78] In depositions, a conflict was discovered that required Ireland to cease representing both Armstrong and Larson. Ireland withdrew as Larson's counsel, but continued to represent Armstrong.[79]

The carrier then filed a declaratory judgment action in federal court, seeking a determination that Armstrong's policy afforded no coverage. Both Armstrong and Larson were named as defendants. The attorney who prosecuted the declaratory judgment action for State Farm was none other than Ireland, who was still defending Armstrong.[80] While admitting State Farm's right to seek a declaratory judgment,[81] attorneys defending Armstrong and Larson in that action moved to disqualify Ireland, alleging his conflict of interest. Ireland opposed the motion on three grounds. First, both defendants were sent reservation of rights letters at the outset of the state court litigation.[82] Second, the defendants were fully advised of the coverage issue, and were also fully advised of their right to retain independent counsel.[83] Third, the coverage dispute was but a separate contractual question for judicial determination which did not compromise his loyalty to Armstrong.[84]

The court in *Armstrong Extinguisher* made short work of Ireland's arguments.

> State Farm has not given equal consideration to Larson's and Armstrong's interests in this case. Mr. Ireland as counsel for Armstrong, and at one time Larson, owes a duty of loyalty to his clients and cannot under the South Dakota Rules of Professional Conduct represent parties with conflicting interests without the consent of all parties after full disclosure of the facts. . . . At the very least, Mr. Ireland's representation of the insurance company in the declaratory judgment action and Armstrong in the underlying litigation creates an appearance of impropriety.[85]

Ireland's decision to simultaneously represent Armstrong and actively work against it created a classic conflict of interest. The court re-

77. 791 F. Supp. 799 (D.S.D. 1992).
78. *Id.* at 800.
79. *Id.*
80. *See id.*
81. *See id.* at 801.
82. *Id.* at 800.
83. *Id.*
84. *Id.*
85. *Id.* at 801.

moved Ireland from the declaratory judgment action and required State Farm to obtain new counsel.[86]

E. Counsel's Defense Activities Generate Information Suggesting a Possible Coverage Defense

Even with informed consent, dual representation creates disclosure and communication problems for insurance defense counsel.[87] Confidential communications pose the thorniest problems for defense attorneys.[88] When appointed counsel learns of information suggesting a possible coverage defense during the course of an insured's representation, an obvious conflict of interest arises. It does not matter whether defense counsel generates the information through independent activities or efforts, or whether the insured shares the information in confidence; in both scenarios defense counsel are generally barred from disclosing the information to the insurer.

In *Parsons v. Continental National American Group*,[89] the insurer, CNA, appointed counsel to defend its insureds, the Smitheys, in connection with their son's alleged assault on three neighbors. The defense attorney's activities led him to believe that the boy's attack of the neighbors was an intentional act and he so informed CNA. The CNA claims representative then sent the Smitheys a reservation of rights letter, stating that the act involved might have been intentional and that their policy specifically excluded liability for bodily injury caused by an intentional act.[90] The case ultimately went to trial and the plaintiffs obtained a $50,000 directed verdict against the insured's son, which was in excess of the $25,000 policy limits. Judgment was then entered in the verdict amount.[91]

The plaintiffs garnished CNA, which responded by offering to settle for its $25,000 policy limits. The plaintiffs declined CNA's offer. CNA successfully defended the garnishment action by asserting its intentional acts exclusion. The same attorney that defended the Smitheys at trial represented CNA in the garnishment action.[92]

The plaintiffs contended that CNA was estopped to deny coverage and waived the intentional acts exclusion because the company exploited the fiduciary relationship between defense counsel and the

86. *Id.* at 802.
87. Hall, *supra* note 8, at 753.
88. *See* Eric M. Holmes, *A Conflicts-of-Interest Roadmap for Insurance Defense Counsel: Walking an Ethical Tightrope Without a Net*, 26 WILLAMETTE L. REV. 1, 63-64 (1989).
89. 550 P.2d 94 (Ariz. 1976).
90. *Id.* at 96.
91. *Id.* at 96-97.
92. *Id.* at 97.

Smithey's son.[93] The court agreed. First noting that the defense attorney obtained privileged and confidential information about the boy by virtue of the attorney-client relationship,[94] the court held:

> When an attorney . . . uses the confidential relationship between an attorney and a client to gather information so as to deny the insured coverage under the policy in the garnishment proceeding we hold that such conduct constitutes a waiver of any policy defense, and is so contrary to public policy that the insurance company is estopped as a matter of law from disclaiming liability under an exclusionary clause in the policy.[95]

CNA was ultimately held liable for the full amount of the excess judgment.[96]

Parsons illustrates attorneys' need to ascertain how to handle confidential information material to both clients, but known only to one. Attorneys who fail to understand their fiduciary obligations unnecessarily expose themselves to malpractice liability. Depending on the jurisdiction, both insured and insurer are potential malpractice plaintiffs.

F. Punitive Damages Are Claimed

Depending on the jurisdiction and the facts of the particular case, a plaintiff who pursues a punitive damage claim may create a conflict of interest. Liability insurers which are not obligated to indemnify their insureds for punitive damage awards[97] may be thought to have no in-

93. *Id.*

94. *Id.*

95. *Id.* at 99.

96. *Id.* at 99-100.

97. The question of insurance coverage for punitive damages plagues courts, insurers, and insureds. Many liability insurance policies do not expressly exclude punitive damages from coverage. Standard policy language providing that an insurer will pay "all sums which the insured shall become legally obligated to pay as damages" is frequently held to be so broad as to include punitive damages. *See, e.g.*, Insurance Reserve Fund v. Prince, 403 S.E.2d 643, 648 (S.C. 1991). In some states, insurance policies covering bodily injury, personal injury, and property damage do not cover punitive damages unless other policy language provides for the payment of punitive damages. *See, e.g.*, Union L.P. Gas Sys., Inc. v. International Surplus Lines Ins. Co., 869 F.2d 1109, 1110-11 (8th Cir. 1989); Heartland Stores, Inc. v. Royal Ins. Co., 815 S.W.2d 39, 42-43 (Mo. Ct. App. 1991). There is a split among jurisdictions as to the insurability of punitive damages. Some states prohibit the insurability of punitive damages as a matter of public policy, fearing that the goals of punishment and deterrence would be undermined by insurance, or that the financial burden resulting from punitive damage awards would ultimately rest with other, blameless insureds. *See, e.g.*, Allen v. Simmons, 533 A.2d 541, 543-44 (R.I. 1987). Jurisdictions which allow punitive damage insurance usually have a much lower threshold for awarding punitive damages, imposing only a gross negligence or similar standard. *See* Continental Cas. Co. v. Fibreboard Corp., 762 F. Supp. 1368, 1371 (N.D. Cal. 1991), *aff'd*, 953 F.2d 1386 (9th Cir.), *vacated*, 113 S. Ct. 399 (1992). For a thoughtful discussion

terest in defending against such claims.[98] Insureds, on the other hand, have a vital interest in avoiding punitive damages. Defense counsel must inform both the insurer and the insured of punitive damage exposure so that they may protect their respective interests.

G. The Insurer Attempts to Limit Discovery to Reduce Expenses

Occasionally an insurer will attempt to restrict defense counsel's discovery activities in an effort to reduce litigation costs. Counsel may be instructed not to propound written discovery, or might be told to forego certain depositions. Such restrictions create potential conflicts of interest if they inhibit an attorney's ability to adequately defend a case, or interfere with the attorney's independent professional judgment. The potential for conflict is aggravated if potential damages exceed coverage, giving the insured a legitimate concern in the litigation result.

Ethics rules generally prevent an attorney from representing a client (the insured) if that representation may be materially limited by the lawyer's responsibilities to another client (the insurer). For example, the *Model Rules of Professional Conduct* provide in Rule 5.4(c) that a lawyer shall not permit one who employs or pays another to represent a client to "direct or regulate the lawyer's professional judgment in rendering such legal services."[99] A defense attorney may have to conduct discovery regardless of an insurer's stated unwillingness to pay. An insured may have to be informed of imposed discovery limitations, or written consent to counsel's continued representation may be required, in order to avoid conflicts.

IV. ETHICS RULES GOVERNING INSURANCE DEFENSE COUNSEL

Although the tripartite relationship is unique to insurance defense, appointed counsel are subject to the same ethics rules that govern their colleagues in other practice areas. Most states have now adopted the American Bar Association's *Model Rules of Professional Conduct*.[100] Several of these rules are directly applicable to insurance defense practice.

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of the insurability of punitive damages, including policy and theoretical bases, see JERRY, *supra* note 2, at 349-54.

98. *See, e.g.*, Emons Indus., Inc. v. Liberty Mut. Ins. Co., 749 F. Supp. 1289, 1298 (S.D.N.Y. 1990).

99. MODEL RULES OF PROFESSIONAL CONDUCT Rule 5.4(c)(1983).

100. Currently, 37 states and the District of Columbia have adopted the *Model Rules of Professional Conduct* with some amendments. Brooke Wunnicke, *The Eternal Triangle Revisited: The Insurance Defense Lawyer and Conflicts of Interest*, FOR THE DEFENSE, Nov. 1993, at 20, 20. This Article does not discuss the *Model Code*

A. Model Rule 1.7

Model Rule 1.7 is the primary rule pertaining to conflicts of interest.[101] Rule 1.7 provides:

> (a) A lawyer shall not represent a client if the representation of that client will be directly adverse to another client, unless:
>
> (1) the lawyer reasonably believes the representation will not adversely affect the relationship with the other client; and
>
> (2) each client consents after consultation.
>
> (b) A lawyer shall not represent a client if the representation of that client may be materially limited by the lawyer's responsibilities to another client or to a third person, or by the lawyer's own interests, unless:
>
> (1) the lawyer reasonably believes the representation will not be adversely affected; and
>
> (2) the client consents after consultation. When representation of multiple clients in a single matter is undertaken, the consultation shall include explanation of the implications of the common representation and the advantages and risks involved.[102]

Rule 1.7(b) applies to situations in which an insurer limits discovery in an effort to reduce litigation costs. Section (b)(2) apparently requires defense counsel who anticipate future conflicts of interest to obtain their dual clients' consent to representation.[103] The rule additionally contemplates dual representation only after both clients have been fully informed about possible benefits and disadvantages.

Comment 10 to Rule 1.7 is also relevant to the tripartite relationship.[104] The comment states:

> A lawyer may be paid from a source other than the client, if the client is informed of that fact and consents and the arrangement does not compromise the lawyer's duty of loyalty to the client. See Rule 1.8(f). For example, when an insurer and its insured have conflicting interests in a matter arising from a liability insurance agreement, and the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel's professional independence.[105]

An insured's execution of the insurance contract may amount to consent to the insurer's payment of legal fees and expenses, so long as defense counsel's loyalty is not compromised.

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of Professional Responsibility which remains in effect in the states that have not adopted some version of the Model Rules. In the remaining Model Code states, "the provisions of the Disciplinary Rules and Ethical Considerations are not substantively different from the Model Rules" discussed in the following text. O'Malley, *supra* note 24, at 516 n.27.

101. *See* O'Malley, *supra* note 24, at 518; Winiarski, *supra* note 30, at 597.

102. MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.7 (1983).

103. Murray and Bringus, *supra* note 3, at 284-85.

104. *See* O'Malley, *supra* note 24, at 519.

105. MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.7 cmt. 10 (1983).

B. Model Rules 1.8(f) and 5.4(c)

Model Rules 1.8(f) and 5.4(c) directly apply to insurance defense practice.[106] The applicability of Rule 1.8(f) is made clear by comment 10 to Rule 1.7. Rule 1.8 addresses conflicts of interest and prohibited transactions. Paragraph (f) provides:

> A lawyer shall not accept compensation for representing a client from one other than the client unless:
>
> (1) the client consents after consultation;
>
> (2) there is no interference with the lawyer's independence of professional judgment or with the lawyer-client relationship; and
>
> (3) Information relating to representation of a client is protected as required by rule 1.6.[107]

Compliance with Rule 1.8(f)(2) may require defense counsel to disagree with the insurer in the control of the litigation. For example, a defense attorney may have to disregard the insurer's instructions with respect to strategic decisions.[108]

Rule 5.4 addresses a lawyer's professional independence. Paragraph (c) states: "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."[109] As noted previously, Rule 5.4(c) comes into play if an insurer attempts to restrict defense counsel's activities in an attempt to hold down defense costs.

C. Fraud and Confidentiality: Model Rules 1.2, 1.16, and 1.6

Insurance fraud is a disturbingly common problem. It is not unheard of for insureds to set fire to buildings they own, report nonexistent losses, or conspire with named plaintiffs. Model Rule 1.2(d) clearly forbids defense counsel from assisting or supporting an insured who is attempting to defraud an insurer. According to Model Rule 1.2(d), "[a] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent . . . ."[110]

Another of the Model Rules related to fraud is 1.16(a)(1). Model Rule 1.16(a)(1) requires defense counsel's resignation from an insured's representation in the face of fraud. The rule provides that an attorney "*shall* not represent a client or, where representation has

106. *See* O'Malley, *supra* note 24, at 519.

107. MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.8(f)(1983).

108. *See* Mallen, *supra* note 5, at 110.

109. MODEL RULES OF PROFESSIONAL CONDUCT, Rule 5.4(c)(1983).

110. *Id.* Rule 1.2(d).

commenced, *shall* withdraw" if representation "will result in violation of the rules of professional conduct or other law . . . ."[111]

Model Rule 1.6 addresses a defense counsel's obligation to maintain confidentiality. In the case of an insured's fraud and defense counsel's mandatory rejection of or withdrawal from representation in accordance with Rule 1.2, the text of Rule 1.6 further requires that counsel not reveal the fraud to the insurer.[112] The "lip-sealing nature"[113] of Rule 1.6's text aside, comment 16 of the Rule provides:

> After withdrawal the lawyer is required to refrain from making disclosure of the client's confidences, except as otherwise provided in Rule 1.6. Neither this Rule nor Rule 1.8(b) nor Rule 1.16(d) prevents the lawyer from giving notice of the fact of withdrawal, and the lawyer may also withdraw or disaffirm any opinion, document, affirmation or the like.[114]

Apparently, then, Rule 1.6 authorizes indirect or discreet disclosure of an insured's fraud by way of a "noisy withdrawal."[115] Some scholars have described such a withdrawal as waving "the red flag."[116]

V. ATTEMPTED SOLUTIONS TO THE DUAL CLIENT DILEMMA

The dual client doctrine (and thus the tripartite relationship) has long been a concern of lawyers and insurers alike. In 1969, the National Conference of Lawyers and Liability Insurers adopted *Guiding Principles* for liability insurers.[117] The American Bar Association House of Delegates formally approved the *Guiding Principles* in 1972.[118] The *Guiding Principles* read as follows:

> I. General Statement
>
> Under a policy providing liability insurance, the company has a direct financial interest in any claim present against its insured which the company may be obligated to defend or pay, and in any suit on such claim, whether or not the company is named as a party. The company has the right to have counsel of its own choice to defend this interest. So long as no conflict of interests exists, that counsel also represents the insured. If and when representation of the company by its attorney conflicts with the interest of the insured,

111. *Id.* Rule 1.16(a)(1)(emphasis added). *See, e.g.*, Montanez v. Irizarry-Rodriguez, 641 A.2d 1079 (N.J. Super. Ct. App. Div. 1994).
112. *See* MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.6 (1983).
113. O'Malley, *supra* note 24, at 517.
114. MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.6 cmt. 16 (1983).
115. Geoffrey C. Hazard, Jr., *Rectification of Client Fraud: Death and Revival of a Professional Norm*, 33 EMORY L.J. 271, 307 (1984); O'Malley, *supra* note 24, at 517.
116. *See, e.g.*, Ronald D. Rotunda, *The Notice of Withdrawal and the New Model Rules of Professional Conduct: Blowing the Whistle and Waving the Red Flag*, 63 OR. L. REV. 455, 484 (1984).
117. *See* NATIONAL CONFERENCE OF LAWYERS AND LIAB. INSURERS, AM. BAR ASS'N, GUIDING PRINCIPLES, *in* FED'N INS. COUNS. Q. Summer 1970, at 93, 93 [hereinafter GUIDING PRINCIPLES].
118. O'Malley, *supra* note 24, at 513.

the company and its attorney are under a duty to inform the insured of such conflict and to invite him to retain his own counsel at his own expense.

II. Claim or Suit in Excess of Limits

In any claim where there is a probability that the damage will exceed the limits of the policy and the company has retained counsel to defend the claim, or in any suit in which the prayer of the complaint exceeds the limit of the policy, or in which there is an unlimited or indefinite prayer for damages and a probability that the verdict may exceed the coverage limit, the company or its attorney should timely inform the insured of the danger of exposure in excess of the limit of the policy. The insured should be invited to retain additional counsel at his own expense to advise him with respect to that exposure. So long as the financial interest of the company in the outcome of the litigation continues, the company retains the exclusive right to control and conduct the defense of the case, in good faith, subject to the right of the insured or such additional attorney to participate.

III. Settlement Negotiations in Claims or Suits With Excess Exposure

In any claim where there is a probability that the damage will exceed the limit of the policy and the company has retained counsel to defend the claim, or in any suit in which it appears probable that an amount in excess of the limit of the policy is involved, the company or its attorney should inform the insured or any additional attorney retained by the insured at his own expense of significant settlement negotiations, whether within or beyond the limits of the policy. Upon request, the insured, or such additional attorney, shall be entitled to be informed of all settlement negotiations. The company shall, upon request, make available to the insured or such additional attorney all pertinent factual information the company and its attorney may have for evaluation by the insured or such additional attorney.

IV. Conflicts of Interest Generally - Duties of Attorney

In any claim or in any suit where the attorney selected by the company to defend the claim or action becomes aware of facts or information which indicate to him a question of coverage in the matter being defended or any other conflict of interest between the company and the insured with respect to the defense of the matter, the attorney should promptly inform both the company and the insured, preferably in writing, of the nature and extent of the conflicting interest. In any such suit, the company or its attorney should invite the insured to retain his own counsel at his own expense to represent his separate interest.

V. Continuation by Attorney Even Though There is a Conflict of Interests

Where there is a question of coverage or other conflict of interest, the company and the attorney selected by the company to defend the claim or suit should not thereafter continue to defend the insured in the matter in question unless, after a full explanation for the coverage question, the insured acquiesces in the continuation of such defense.

If the insured acquiesces in the continuation of the defense in the pending matter following a reservation of rights by the company or under an agreement that the rights of the company and the insured as to the coverage question are not waived or prejudiced, the company retains the exclusive right to control and conduct the defense of the case in good faith, subject to the right of the insured or the additional attorney acting at the expense of the insured to participate.

If the insured refuses to permit the insurance company and the attorney selected by the company to defend the claim or suit to continue the defense of the pending matter while reserving the rights of the company and of the insured as to the coverage question, or if the full protection of the separate interests of the insured and the company requires inconsistent contentions which

cannot be presented in a common defense of the pending matter, the insurance company or the insured should seek other procedures to resolve the coverage question.

If facts or information indicating to the attorney a lack of coverage for the insured should first come to the attention of the attorney after the trial for the lawsuit has begun, the attorney should at the earliest opportunity inform and advise the insured and the company of the possible conflicting interests of the insured and the company. The attorney should further seek to provide both the insured and the company with time and the opportunity to consider the possible conflict of interests and to take appropriate steps to protect their individual interests.

VI. Duty of Attorney Not to Disclose Certain Facts and Information

Where the attorney selected by the company to defend a claim or suit becomes aware of facts or information, imparted to him by the insured under circumstances indicating the insured's belief that such disclosure would not be revealed to the insurance company but would be treated as a confidential communication to the attorney, which indicate to the attorney a lack of coverage, then as to such matters, disclosures made directly to the attorney, should not be revealed to the company by the attorney nor should the attorney discuss with the insured the legal significance of the disclosure or the nature of the coverage question.

VII. Counterclaims

In any suit where the company or the attorney selected by the company to defend the suit becomes aware that the insured may have a claim for damages against another party to the lawsuit, which is likely to be prejudiced or barred unless it is asserted as a counterclaim in the pending action, the insured should be advised that the pending suit may affect or impair such claim, that the insurance policy does not provide coverage for any legal services or advice as to such claim, and that the insured may wish to consult an attorney of his choice with respect to it.

VIII. Suit Involving More Than One Insured in The Same Company

If the same company insures two or more parties to a lawsuit, whose interests are diverse, the complete factual investigation made by the company should be made available to each insured or his attorney with the exception that any statement given by one insured or his employees shall not voluntarily be given to any other party to the litigation whose interest may be adverse to such insured or to any attorney representing such other party.

The company should employ separate attorneys not associated with one another to defend each insured against whom any suit is brought, if the interest of one such insured is diverse from or in conflict with that of any other insured; and all insured should be informed by the company of the fact that it insures the liability of the others and the method being employed to handle the litigation.

IX. Withdrawal

In any case where the company or the attorney selected by the company to defend the suit decides to withdraw from the defense of the action brought against the insured, the insured should be fully advised of such decision and the reasons therefor; and every reasonable effort should be made to avoid prejudice to or impairment of the rights of the insured.

X. Uninsured Motorist Coverage

The company should employ separate attorneys not associated with one another to defend the company against a claim by the insured under the Uninsured Motorist Coverage, and to defend the insured in any suit brought against the insured arising out of the same accident. If the controversy regarding the Uninsured Motorist Coverage has been disposed of before a law-

> suit has been commenced against the insured, the same attorney who defended the company for the first instance could represent the insured in the later lawsuit.
>
> Any statement made by the insured to the company with respect to the defense of any claim made against him arising out of the same accident should not be used against the insured in order to defeat the insured's claim under the Uninsured Motorist Coverage.[119]

The ABA rescinded the *Guiding Principles* in August 1980, under pressure from the Antitrust Division of the Justice Department.[120]

The *Guiding Principles* are now widely disregarded, having been contradicted by subsequent case law, ethics opinions, and the widespread adoption of the *Model Rules of Professional Conduct.*[121] *San Diego Navy Federal Credit Union v. Cumis Insurance Society,*[122] in which the California Court of Appeal held that the insured was entitled to separate counsel *at the insurer's expense*, eviscerated Principles I, II, III, IV and V. The *Guiding Principles* were otherwise flawed. For example, Principle VI provided that "[w]hen the attorney . . . becomes aware of facts or information . . . which indicate to the attorney a lack of coverage . . . the attorney [should not] discuss with the insured the legal significance of the disclosure or the nature of the coverage question."[123] No responsible ethics authority would suggest that insurance defense counsel should not discuss with the insured material coverage issues.[124] Today, Principle VI would certainly run afoul of the *Model Rules of Professional Conduct.* Rule 1.4(b) requires a lawyer to "explain a matter of the extent reasonably necessary to permit the client to make informed decisions regarding the representation."[125] In summary, the *Guiding Principles* are outdated and do not offer reliable guidance.

California, again at the forefront of insurance litigation, has attempted to legislate a solution to some of the problems arising out of the tripartite relationship.[126] Section 2860 of the California Civil Code provides:

> (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 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.

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119. GUIDING PRINCIPLES, *supra* note 117, at 95-99.
120. *See* O'Malley, *supra* note 24, at 513.
121. *See id.*
122. 208 Cal. Rptr. 494 (Ct. App. 1984).
123. GUIDING PRINCIPLES, *supra* note 117, at 97-98.
124. O'Malley, *supra*, note 24, at 514.
125. MODEL RULES OF PROFESSIONAL CONDUCT, Rule 1.4(b)(1983).
126. *See* CAL. CIV. CODE § 2860 (West 1993).

(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 obligations 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 selected 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.[127]

The California statute was central to the court's decision in *Blanchard v. State Farm Fire and Casualty Co.*,[128] among the latest cases reining in *Cumis*.

Florida has also attempted to legislate a solution, albeit limited in scope.[129] The Florida statute provides that in order to deny coverage,

127. *Id.*

128. 2 Cal. Rptr. 2d 884, 887 (Ct. App. 1991).

129. *See* FLA. STAT. ANN. § 627.426(2)(West 1984).

a liability insurer must first send a reservation of rights letter within thirty days after it knew or should have known of a coverage defense.[130] Then, within a limited period, the insurer must either refuse a defense, obtain a nonwaiver agreement, or retain independent counsel mutually agreeable to the parties.[131] The parties may agree on reasonable fees to be paid independent counsel; if they are unable to agree, fees will be set by the court.[132]

VI. PROPOSED RESOLUTION OF CONFLICTS

Conflicts arising out of the tripartite relationship pose genuine problems for insurance defense practitioners. The last several years have seen a dramatic increase in legal malpractice suits;[133] the dual client doctrine makes insurance defense counsel particularly susceptible to malpractice claims. Insurers face the constant threat of bad faith litigation and the accompanying potential for extracontractual damages. Across the table, insureds denied loyal and competent representation are threatened with financial ruin.

Various scholars and commentators have suggested reforms. While some have suggested revising the basic liability insurance contract, most suggestions for reshaping the insurer-insured relationship to minimize conflicts have been rejected as unworkable. There is no provision that can be written into an insurance policy that can alter defense counsel's ethical obligations or eliminate the conflicts that arise when coverage is disputed.[134] Ronald E. Mallen, a preeminent legal malpractice scholar, has suggested that insurers market defense counsel.[135] Essentially, an insured should be given recommendations regarding several defense attorneys approved by the insurer "rather than an assignment as a *fait accompli*."[136] The insurer's fundamental objective is demonstration to its insured that representation by appointed defense counsel is desirable. ALAS's Robert E. O'Malley pro-

130. *Id.* at (2)(a).
131. *Id.* at (2)(b).
132. *Id.*
133. Almost 40% of law firms responding to a survey indicated that legal malpractice claims were made against them between 1990 and 1992. For those firms with 41 or more attorneys, nearly 60% had legal malpractice claims filed against them. David A. Schaefer, *Avoiding Malpractice Claims: Help Yourself Because Juries Won't*, 60 DEF. COUNS. J. 584, 584 (1993). Conflicts of interest may affect attorneys' malpractice exposure in two ways. First, conflicts may form the basis of a malpractice action. Second, even if the gravamen of the plaintiff's complaint is unrelated, a conflict of interest may taint the case and complicate the defense. *See* Robert E. O'Malley et al., Selected Conflicts of Interest Issues, Loss Prevention Program (Attorneys' Liab. Assurance Soc'y, Inc., Bermuda), June 14, 1991, at 42 (materials on file with the author).
134. *See* Mallen, *supra* note 5, at 120.
135. *See id.* at 122-23.
136. *See id.* at 124 (emphasis added).

poses a set of "Guiding Principles II."[137] The "Guiding Principles II" are advocated as a means of providing insureds with loyal and compe-

137. The Guiding Principles II have at their heart simplification of the dual client doctrine. They are:

1. An environment that facilitates the detection and punishment of insurance fraud is a fundamental objective.
2. As a general proposition, an insurance company is a client of its designated defense counsel vis-a-vis the entire world of nonclients.
3. When a lawyer is assigned by the insurer to represent an insured, that lawyer must consult with and obtain the consent of the insured as specified in Model Rules 1.7(b) and 1.8(f). Such consultation with the insured shall include (i) an explanation of the insurer's periodic reporting requirements, (ii) a discussion of the extent to which the insurance policy permits the insurer to settle within policy limits without the consent of the insured, and (iii) defense counsel's limited responsibility as described in principles 7 and 8 below.
4. The insured has the option to refuse consent and retain counsel of the insured's choice at the insured's expense. In that event, these principles *as such* are no longer applicable. It should, however, be recognized by the insured and defense counsel that much of the conduct prescribed for the insured and defense counsel in these principles is also mandated by applicable law, legal ethics codes, and the insurance policy's provisions.
5. Assuming the insured agrees to be represented by the insurer's designated defense counsel, *for all purposes as to that particular matter the insured is the only client of that lawyer.*
6. From the outset of any such matter referred to in principle 5 above, whether or not there is any conflict or potential conflict between insured and insurer, and regardless of whether or when any such conflict or potential conflict is later identified, the insurance company is not for any purpose a client of defense counsel.
7. In the situations referred to in principles 5 and 6 above, the defense counsel's duty as lawyer for the insured is restricted to:
   a. defending the liability claim competently;
   b. exercising independent professional judgment on behalf of the insured as required by Model Rules 1.8(f) and 5.4(c);
   c. advising the insured regarding the insured's contractual (and, if necessary, extra-contractual) rights and obligations under the policy (*e.g.*, if the policy so provides, the insurer's right to settle within policy limits without the insured's consent); and
   d. within the limitations of defense counsel's general ethical obligations (see principle 11, below), conducting the liability defense so as to place the insured in the most favorable posture with respect to any actual or potential coverage dispute, or other dispute between insured and insurer.
8. Except as is otherwise implicit in principle 7 above, defense counsel shall not represent or advise or otherwise be involved with either the insured or the insurer with respect to any coverage dispute or any other dispute between the insured and the insurer.
9. As the lawyer for the insured for the limited purposes described in principle 7 above, defense counsel has no fiduciary duty to the insurer and has no duty to the insurer based on any concept of a lawyer-client relationship, *as to that particular matter.*
10. Apart from defense counsel's general ethical obligations (see principle 11 below), defense counsel's obligation to the insurer is based solely on defense counsel's role as agent for the insured. The obli-

gation is no greater and no less than that of the insured under the provisions of the insurance policy and generally applicable law.

11. As a matter of legal ethics, defense counsel has the same obligations to the insurer and to the plaintiff that would be owed in any matter to any third party who is not a client. These obligations include:
    a. not lying;
    b. not assisting a crime or fraud by the insured;
    c. resigning if the insured is engaged in a crime or fraud;
    d. not asserting a nonmeritorious claim; and
    e. taking remedial action if the insured intends to commit, or has committed, perjury.
12. If defense counsel has resigned pursuant to Model Rule 1.16(a)(1) because the insured is attempting to perpetrate a crime or fraud, defense counsel, pursuant to comments [15] and [16] under Model Rule 1.6, shall give the insurer notice of defense counsel's withdrawal, and following the resignation shall also "withdraw or disaffirm any opinion, document, affirmation, or the like" previously submitted by defense counsel to the insurer or to the court that contains a material misrepresentation, omission or similar material falsehood.
13. Except for the indirect disclosure that is inherent in the resignation and document withdrawal scenario described in principle 12 above, defense counsel may not inform the insurer of the insured's crime or fraud. In general, defense counsel may not inform the insurer of *anything* adverse to the insured vis-a-vis the insured's relationship with the insurer, not even the potential (but unspecified) conflict of interest. Under these principles, any dispute or potential dispute between the insured and the insurer does not create a conflict of interest problem for defense counsel because defense counsel's only client is the insured. On the other hand, nothing contained in these principles prohibits defense counsel from disclosing to the insurer negative information about the insured that bears materially on the defense of the case, such as the credibility and impeachability of the insured and the degree of culpability of the insured.
14. The nondisclosure rules contained in principle 13 above are subject to any contrary explicit provisions of the ethics code in effect in any given jurisdiction.
15. The insured, having originally consented to be represented by the designated defense counsel within the framework of these principles, has no right at any time thereafter to demand representation by a separate or additional counsel at the expense of the insurer, except in the rare case where changed circumstances (not covered by these principles) later created a serious conflict of interest on the part of defense counsel that under general principles of legal ethics is not waivable by the insured.
16. In any case where defense counsel has withdrawn from the representation of the insured, or otherwise for any reason ceases to represent the insured, the insurer continues to have the right to designate a successor defense counsel (who shall be subject to these principles) to the same extent as that right existed under the policy with respect to designation of the original defense counsel.
17. The insured may at any time and for any reason retain separate counsel at his or her own expense to advise the insured as to any and all aspects of the matter. In such an event, the designated defense counsel shall, in good faith, consult with the insured's special counsel with a view to achieving mutual agreement as to what strategy and tactics are in the best interests of the insured.

tent representation, protecting liability insurers' legitimate interests, and eliminating the expense and other negatives associated with the engagement of independent counsel for insureds.[138] The "Guiding Principles II" count as advantages their grounding in existing ethics rules, and the fact that they neither contemplate nor require changes in policy language or accepted industry practice. Finally, defense expense coverage and indemnification coverage might be separated, and provided by different insurers.[139] Although the creation of defense expense insurance might present a variety of potential problems or disadvantages,[140] it would eliminate most conflicts of interest and might reduce potential bad faith actions against insurers.[141]

Regardless of option, "[t]he key to reform is a level playing field with bright lines."[142] Whether bright lines can, in fact, be drawn is an open question; the eternal triangle of insurance defense is an area of constant legal flux. Realizing that practical advice often complements theoretical discussion, and wary of hard and fast rules or solutions, the following discussion represents a modest attempt to craft some broad professional guidelines. The goal, of course, is avoiding or mitigating conflicts of interest in practice.

First, defense counsel must treat the insured as the client. Recognizing the insured as the attorney's sole client is consistent with recent judicial decisions.[143] Appointed counsel's continuing business relationship with the insurer must not be allowed to interfere with the

18. Notwithstanding the presence of separate counsel for the insured as described in principal 17 above, the defense counsel and the insurer shall continue to control the defense to the extent contractually provided in the insurance policy.
19. In the case of any dispute or potential dispute between insured and insurer, the insurer may be represented by its officers and employees in addition to counsel of its choice (other than defense counsel). In such a case, the insured and defense counsel shall provide information to the insurer in accordance with any contractual obligations flowing from the insurance policy and in accordance with their obligations under the generally applicable law.

O'Malley, *supra* note 24, at 521-25.

138. *See id.* at 520.
139. *See* Alan I. Widiss, *Abrogating the Right and Duty of Liability Insurers to Defend Their Insureds: The Case for Separating the Obligation to Indemnify from the Defense of Insureds*, 51 OHIO STATE L.J. 917, 939 (1990).
140. Potential disadvantages include higher total premiums, increased defense costs, complexity introduced by the involvement of an additional insurer, loss of the liability insurer's expertise, fostering opportunities for the insured and counsel to structure the third-party litigation so as to bring any judgment within the scope of the coverage, and disputes between the insured and the indemnification carrier with respect to litigation management or settlement. *See id.* at 940-42.
141. *Id.* at 942-45.
142. O'Malley, *supra* note 24, at 520.
143. *See, e.g.*, Continental Cas. Co. v. Pullman, Comley, Bradley & Reeves, 929 F.2d 103, 108 (2d Cir. 1991); *In re* A.H. Robins Co., 880 F.2d 694, 751 (4th Cir.), *cert. denied*, 493 U.S. 959 (1989); First Am. Carriers, Inc. v. Kroger Co., 787 S.W.2d

duties of confidentiality, disclosure, honesty, and loyalty owed the insured. Perhaps the best practice is for defense counsel to write both the insurer and insured when first engaged to explain or delineate ethical duties under state law, including the nature or circumstances of expected communications, the insured's right to select independent counsel at its expense, and the conduct of settlement negotiations. The insured should also be informed of the insurer's right to control the defense. If the insurer does not do so in its initial letter to its insured, defense counsel may also need to inform the insured about coverage limits, whether the coverage limits are declining, and the insured's duty to cooperate. Most insurers expect an acknowledgment letter following a defense assignment, and they are also sensitive to coverage issues and conflicts of interest. Carriers involve separate coverage counsel as warranted. Including in an insurer's acknowledgment letter the sort of information outlined above, and similarly communicating with the insured, should pose little business difficulty for defense counsel.

At the same time, treating the insured as the client does not relieve a defense attorney of certain obligations to the insurer. Basically, defense counsel must strive to fulfill all of the insurer's claims-handling requirements.[144] Counsel must satisfy all reporting requirements, timely inform the insurer of case developments, consult with claims representatives regarding matters such as defense expenditures and the engagement of expert witnesses, and involve the insurer in all settlement matters. Defense counsel's reports should detail the case's procedural status, highlight important factual developments, outline defense strategy, analyze liability and damage potential, and indicate settlement possibilities.[145]

Second, defense counsel must ascertain how to deal with confidential information under applicable state law. As a general rule, a defense attorney should never share with the insurer confidential information communicated by the insured. If defense counsel learns of information suggesting coverage defenses, such information must be kept confidential. Under no circumstances should appointed counsel attempt to uncover or develop coverage defenses. Depending on the facts and the jurisdiction, counsel may have to withdraw.

Third, defense counsel should exercise great caution if asked to represent multiple insureds. At the outset, a defense attorney representing two or more insureds should analyze potential conflicts, disclose potential conflicts to each insured, and obtain valid waivers. Counsel must closely monitor potential conflicts as the case pro-

669, 671 (Ark. 1990); Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294, 297-99 (Mich. 1991).

144. *See* Winiarski, *supra* note 30, at 599.

145. *See id.* at 600.

gresses, because conflicts may develop to the point of requiring withdrawal. Any attorney attempting multiple representation must objectively determine that no client's interests will be impaired.

Finally, an insured should be consulted with respect to settlement even when the proposed settlement is entirely within policy limits and the policy reserves to the carrier exclusive control over settlement decisions.[146] This advice is particularly applicable to cases in which the defendant is a professional.[147] For example in *Rogers v. Robson, Masters, Ryan, Brumund and Belom*,[148] the Illinois Supreme Court held that defense counsel were obligated to disclose to the insured the insurer's intent to settle a malpractice case without his consent, and contrary to his express instructions.[149] The attorneys' duty to make such disclosure stemmed from their attorney-client relationship with the insured, regardless of the insurer's broad contractual authority to settle without its insured's consent.[150] In *Arana v. Koerner*,[151] the Missouri Court of Appeals observed that defense counsel breached their duty of "good faith and fidelity" to an insured by ignoring his instructions to litigate, rather than settle, a malpractice suit.[152]

At a minimum, defense counsel must inform insureds of their insurers' intent to settle. The insureds may then assert whatever common law rights they may have.

VII. CONCLUSION

Insurance defense counsel are presented with a variety of ethical dilemmas attributable to the unique tripartite relationship they share with insurers and their insureds. Appointed counsel may encounter conflicts of interest when they are first assigned the defense, during discovery, while shaping litigation strategy, and in settlement negotiations.[153] When a conflict appears and the usually harmonious relationship between insurer and insured is disrupted, an "elaborate minuet" ensues.[154] As Robert E. O'Malley of the ALAS explains:

146. If an insured must ultimately pay a settlement as part of its deductible, the insured must consent to settlement. *See* St. Paul Fire & Marine Ins. Co. v. Edge Memorial Hosp., 584 So. 2d 1316 (Ala. 1991).

147. "Some states have created what might be called a 'professional liability' exception to the general rule granting the carrier exclusive control over settlement decisions." Murray & Bringus, *supra* note 3, at 288.

148. 497 N.E.2d 47 (Ill. 1980).

149. *See id.* at 49.

150. *Id.* The *Rogers* holding has been roundly criticized. *See, e.g.*, Mitchum v. Hudgens, 533 So. 2d 194, 196-97 (Ala. 1988).

151. 735 S.W.2d 729 (Mo. Ct. App. 1987).

152. *Id.* at 733. *But cf. In re* Allstate Ins. Co., 722 S.W.2d 947, 952 (Mo. 1987)("[T]he insurer may accept a settlement offer even though the insured wants to go to trial to establish freedom from fault.").

153. Hall, *supra* note 8, at 762.

154. O'Malley, *supra* note 24, at 516.

> This dance is nerve-racking for defense counsel and often severely prejudicial to the insured. The identification of a conflict, its disclosure, the ensuing discussions, and (in some cases) the resignation of the original defense counsel have the effect of notifying the insurer that facts may exist that are prejudicial to the insured. For example, there may be a coverage defense that the insurer would not have become aware of without defense counsel's tacit notice. When the conflict of interest issue arises and defense counsel resigns, the insurer is alerted to the need for further investigation. Often, without any additional disclosure by defense counsel, the insurer will discover the facts that are prejudicial to the insured.[155]

When the dance ends, defense counsel may find themselves subject to malpractice claims by both insureds and insurers.[156]

The avoidance of conflicts of interest depends on early recognition. If a defense is provided under a reservation of rights, counsel must determine if the issue on which coverage hinges is within counsel's control when defending the underlying claim. Might a potential conflict be avoided by full disclosure and the insured's consent to representation? The resolution of conflicts depends on the facts of the particular case and, in many instances, on the law of the forum state. Certain principles transcend jurisdictional boundaries: defense counsel must serve insureds loyally and with the fidelity afforded all other clients; client confidences must be respected, communication obligations having been established in advance; the representation of multiple insureds should be carefully scrutinized; and insureds and insurers must be involved in settlement.

The tripartite relationship between insurer, insured, and insurance defense counsel creates problems that "would tax Socrates, and no decision or authority . . . furnishes a completely satisfactory answer."[157] The best one can hope for is a greater understanding of this dynamic area of law.

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155. *Id.* at 516.

156. Many jurisdictions permit liability insurers to maintain malpractice actions against defense counsel. *See* Glenn v. Fleming, 781 P.2d 1107 (Kan. Ct. App. 1989); Friesens v. Larson, 438 N.W.2d 444 (Minn. Ct. App.), *rev'd on other grounds*, 443 N.W.2d 830 (Minn. 1989); Nationwide Mut. Ins. Co. v. Winslow, 382 S.E.2d 872 (N.C. Ct. App. 1989). Some states allow insurers to pursue defense counsel under an equitable subrogation theory in the absence of an attorney-client relationship. *See, e.g.*, Atlanta Int'l Ins. Co. v. Bell, 475 N.W.2d 294, 297-99 (Mich. 1991).

157. Hartford Accident & Indem. Co. v. Foster, 528 So. 2d 255, 273 (Miss. 1988).