

Conflict Situations

The Insured's Right to Select Defense Counsel

Part One of a Two-Part Article

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When a primary insurer reserves the right to deny indemnity coverage for a suit against its insured, it often must allow the insured to select defense counsel for that suit. As courts have routinely held, at least in some circumstances, if there is a conflict of interests between the policyholder and the insurer because of a reservation of rights, the insured may select independent counsel, whose fees will be borne by the insurer under its defense obligation.

But when the insurer does not reserve the right to deny coverage, can there still be a conflict sufficient to vest the right to select counsel in the policyholder? This article argues that in lawsuits in which the potential liability is substantially greater than the primary policy's limit, the policyholder should be entitled to select its own defense counsel. The logic that applies in the reservation-of-rights context leads to the same result in the major exposure context.

THE INSURED'S RIGHT TO SELECT COUNSEL

Primary liability policies typically contain two independent promises by the insurer. First, if there is a suit against the insured that seeks damages potentially covered by the policy, the insurer will defend the insured against that suit. Second, if there is a covered liability, the insurer will pay

for the settlement by, or the judgment against, the insured. These promises are known as the duty to defend and the duty to indemnify. Because the duty to defend is typically not subject to a dollar limit, it can be even more valuable to the insured than the duty to indemnify.

Typically, when fulfilling its duty to defend, the insurer may select counsel to defend its insured. In many if not most cases, this arrangement makes sense, as it is the insurer's dollars that are at stake in the event of a settlement or judgment.

But when there is a conflict of interests between the insured and the insurer, different rules often apply. In the classic example of a complaint that alleges both negligence and an intentional tort, which we will call a "mixed action" complaint, the interests of the insured and its insurer can easily diverge. Specifically, if the insurer reserves the right to deny indemnity coverage for any judgment based on intentional or willful injury, a conflict has been created. Although the insurer and the policyholder both have an interest in defeating the claim in its entirety, the insurer's interests would be equally well served by a finding of intentional injury, whereas the policyholder's interests would be advanced by a finding of negligence. See, e.g., *Employers' Fire Ins. Co. v. Beals*, 240 A.2d 397, 400 (R.I. 1968), overruled in part on other grounds, *Peerless Ins. Co. v. Viegas*, 667 A.2d 785 (R.I. 1995).

Most jurisdictions recognize that if the insurer could select defense counsel to represent the insured in such a case, the counsel so selected would be caught in the conflict of those competing interests. Specifically, counsel trying to please the insurer that retained her to defend a "mixed action" case would have an incentive to steer the case toward a

finding of intentional tort, even though this would be at odds with the interests of the insured. Even if counsel's ethical obligation ran solely to the insured, there would still be real-world pressures on the lawyer — pressures that the law has determined are unacceptable.

KEY CASES

The best-known case addressing this issue is *San Diego Navy Federal Credit Union v. Cumis Insurance Society, Inc.*, 162 Cal. App. 3d 358 (1984), from which the term "Cumis counsel" (meaning "independent, policyholder-selected counsel") derives. As the trial court in that case put it, a lawyer who is dependent on insurers "would be tempted to [promote the interests of] his real client, the Carrier Company, as opposed to the Insured, for whom he will never likely work again A lawyer who does not look out for the Carrier's best interest might soon find himself out of work." *Id.*, 162 Cal. App. 3d at 364 (quoting the trial court).

Many other courts and commentators have arrived at the same conclusion. See, e.g., *United States Fid. & Guar. Co. v. Roser*, 585 F.2d 932, 938 n.5 (8th Cir. 1978) ("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 [i.e.,] the one who is paying his fee and from whom he hopes to receive future business[:] the insurance company."); *Nandorf, Inc. v. CNA Ins. Cos.*, 479 N.E.2d 988, 991 (Ill. App. Ct. 1985) (acknowledging that the attorney owes ethical duties to the insured but recognizing that "in reality, [the insurer's chosen attorney] may have closer ties with the insurer and a more compelling interest in protecting the insurer's position")

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(internal quotation marks omitted); 22 Eric Mills Holmes, *Holmes' Appleman on Insurance* 2d § 136.9[C][1], at 73 (2003) ("When a conflict arises [between insured and insurer], there is a danger that the attorney appointed by the insurer may find it financially advantageous to protect the insurer's interests before those of the insured. By virtue of being retained by the insurer, the attorney's loyalty is often to the insurer.").

THE NECESSARY INDEPENDENCE

As these courts and commentators have noted, allowing the policyholder to select defense counsel assures the necessary independence because it solves the structural problem that arises from a lawyer's dependence on insurers for a significant source of his or her business. See, e.g., *Beals*, 240 A.2d at 403-04 (allowing the insured to select defense counsel, whose fees will be paid by the insurer).

THE MAJOR EXPOSURE CASE AS A SOURCE OF CONFLICT OF INTERESTS

Conflicts of interests between insured and insurer can arise in contexts other than the "mixed action" case. For example, in what we term the "major exposure case," a policyholder may face potential liability in an amount far greater than the indemnity limit of the primary policy. In such a case, the substantial disparity between the policy limit and the potential liability of the insured can create a conflict of interests concerning the management of the defense of the lawsuit.

Although one can find the occasional commentator who contends that the risk of an excess judgment cannot create a conflict between the policyholder and its insurer, this position is readily refutable. First of all, other legal-ethics authorities have reached the contrary conclusion. As the Restatement of the Law Governing Lawyers recognizes, "[m]aterial divergence of interest might exist between a liability insurer and

an insured, for example, when a claim substantially in excess of policy limits is asserted against an insured." Restatement (Third) of the Law Governing Lawyers § 134 cmt. f (2000). Accord, e.g., *In re the Rules of Prof. Conduct and Insurer Imposed Billing Rules and Procedures*, 2 P.3d 806, 813 (Mont. 2000) ("In cases where an insured's exposure exceeds his insurance coverage ... there are potential conflicts of interest."); Todd R. Smyth, Annotation, "Duty of Insurer to Pay for Independent Counsel When Conflict of Interest Exists Between Insured and Insurer," 50 A.L.R.4th 932, at § 2[a] (2009) ("Another situation in which a conflict of interest between the insured and the insurer may arise is where the complaint seeks damages in excess of the policy limits.").

Second, as a matter of economics, one can readily envision how the disparity in a major exposure case could generate a conflict. Specifically, the conflict comes about because the insured is interested in a vigorous defense that reflects its potential exposure, whereas the insurer has an interest in limiting its defense spending, or spending only an amount that reflects its own exposure, which is capped by the policy's indemnity limit. See, e.g., Ronald D. Rotunda & John S. Dzienkowski, *Legal Ethics — The Lawyer's Deskbook on Professional Responsibility* at 391 (ABA Center for Professional Responsibility 2009-10 ed.) (a conflict can arise because "the insurer may wish to spend less on lawyers' fees to defend the lawsuit than the insured prefers").

CASE LAW

Third, such conflicts have arisen in the real world and have been recognized in the case law. The case of *Emons Industries, Inc. v. Liberty Mutual Insurance Co.*, 749 F. Supp. 1289 (S.D.N.Y. 1990), provides a noteworthy example. Emons was a defendant in bodily injury cases arising out of DES, a synthetic estrogen drug. See *Id.* at 1290. Emons's insurer, Liberty Mutual, acknowledged its defense obligation, but

insisted on choosing defense counsel. See *Id.* at 1291. Emons argued, among other things, that Emons and Liberty Mutual had a conflict of interests with respect to the defense of the DES cases and that therefore Emons, rather than Liberty Mutual, had the right to select counsel. See *Id.* at 1297. The District Court agreed.

In holding that there were "substantial conflicts of interest" between Emons and Liberty Mutual, the District Court evaluated the economic incentives of the two parties in light of the claims and the policy limits. Noting that most of the claims against Emons sought a dollar amount above the policy's applicable per-claim limit, the court observed that Liberty Mutual had a "strong interest" in "reducing the defense costs it must pay by quickly settling these cases irrespective of whether they are reasonable or are within the per claim limit." *Id.* This strategy would not only reduce the defense costs per claim defended, but also would allow Liberty Mutual to reach its annual aggregate indemnity limit and thereby cut off defense under the exhausted policy. By contrast, the policyholder's interest was in "vigorously defending these suits and obtaining the lowest possible settlement or judgment." *Id.*

As the *Emons* case establishes, an insured and its insurer can have conflicting litigation and settlement strategies, with those strategies driven by the gulf between the insurer's limited exposure and the policyholder's potentially greater exposure, as well as by the fact that the insurer's promise to pay defense costs is unlimited. Indeed, given this uncapped defense duty, in a major exposure case, the insurer's larger exposure is often the defense costs, which, in such a case, can easily outstrip even a multimillion-dollar indemnity limit.

We continue this discussion in depth in next month's issue.

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