Cumis Test
When Does the Right to Independent Counsel Vest?

Introduction

Since its publication over three decades ago, the landmark[1] *Cumis*[2] decision has been validated by the California Legislature[3], the Supreme Court[4], and a well developed body of California law: When potential conflicts arise between a liability insurer and its policyholder - often by a reservation of rights letter - the policyholder, not the insurer, may to select and direct independent counsel to conduct a policyholder's defense of a third party liability dispute at a liability insurer's expense. This right vests unless the insurer's reservation of rights is limited to grounds that have "nothing to do with the issues being litigated in"[5] a third party liability dispute - generally such as non-payment of premium or violation of a policy condition.[6]

The Cumis Test

The substantive legal test in California to determine whether a reserving insurer must pay for independent counsel has been expressed in a variety of ways, both negatively and positively. Some reported opinions collect cases that do and do not require an insurer to pay for independent counsel. "[T]he insurer may have more than one defense to coverage. In that event, the trial court will need to consider each defense separately."[7] "In the absence of dispute over some underlying fact, the existence of a conflict is a question of law for the trial judge to decide, not a jury

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[1] LexisNexis rates the Cumis decision among the ten most significant liability coverage cases of all time. https://www.lexisnexis.com/legalnewsroom/insurance/b/insurance-coverage/archive/2015/02/19/the-10-most-significant-liability-coverage-cases-of-all-time.aspx#sthash.84WjDLV0.dpuf

[2] *San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358 (*Cumis*).

[3] "The Cumis opinion was codified in 1987 by the enactment of Civil Code section 2860, which 'clarifies and limits' the rights and responsibilities of insurer and insured as set forth in Cumis." (*James 3 Corp. v. Truck Ins. Exchange* (2001) 91 Cal.App.4th 1093, 1100 (*James 3*) (citation omitted).)

[4] *Hartford Cas. Ins. Co. v. J.R. Marketing* (2015) 61 Cal.4th 988, 992, fn1 (*J.R. Marketing*).

[5] "[W]hen the reservation of rights is based on coverage disputes that have nothing to do with the issues being litigated in the underlying action there is no conflict of interest, and no duty to appoint independent counsel." (*Long v. Century Indemnity Co.* (2008) 163 Cal.App.4th 1460, 1470 (*Long*) (citation omitted).)

[6] See, *Anatomy of a Liability Insurance Policy - Part 4: The Remainder of the Policy* at DutytoDefend.com.

[7] *Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 306 (conc. opn. of Kennard, J.) (*Montrose I*).

question."[8]

Expressed negatively, a liability insurer that reserves its rights *is not required* to pay for independent counsel if each ground upon which the insurer may later deny coverage: 1) has "nothing to do with the issues being litigated in the underlying action;"[9] 2) "is logically unrelated to the issues of consequence in the underlying case;"[10] 3) "is independent of the issues in the underlying case;"[11] 4) "is extrinsic to the issues in the underlying action;"[12] or "can be controlled by counsel first retained by the insurer for the defense of the claim."[13]

Expressed positively, a liability insurer that reserves its rights *is required* to pay for independent counsel: 1) "whenever [the insurer's and policyholder's] common lawyer's representation of the one is rendered less effective;"[14] 2) if coverage issues "overlap" issues in the third party liability action;[15] 3) if any coverage question depends "upon the insured's own conduct;"[16] 4) if "[i]nsurance counsel had [an] incentive to attach liability to [the insured];"[17] 5) "the ground of noncoverage was based on the nature of the insured's conduct;"[18] 6) "the outcome of the coverage issue can be controlled by the way counsel defends the case;"[19] 7) "the way counsel retained by the insurance company defends the action will affect an underlying coverage dispute between the insurer and the insured;"[20] 8) "the basis for the reservation of rights is such as to cause assertion of factual or legal theories which undermine the positions to be asserted in

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[8] *Blanchard v. State Farm Fire & Casualty Co.* (1991) 2 Cal.App.4th 345, 350 (*Blanchard*).

[9] *Long, supra*, 163 Cal.App.4th at 1470 (citation and ellipsis omitted).

[10] *Montrose I, supra*, 6 Cal.4th at 302.

[11] *Blanchard, supra*, 2 Cal.App.4th 345; see also, *Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388, 1422 (*Gafcon*).

[12] *Gafcon, supra*, 98 Cal.App.4th at 1422.

[13] Civ. Code § 2860(b).

[14] *Spindle v. Chubb/Pacific Indemnity Group* (1979) 89 Cal.App.3d 706, 713.

[15] *United Enterprises, Inc. v. Superior Court* (2010) 183 Cal. App. 4th 1004, 1010.

[16] *Foremost Ins. Co. v. Wilks* (1988) 206 Cal.App.3d 251, 261 (*Wilks*).

[17] *Gulf Ins. Co. v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2000) 79 Cal.App.4th 114, 131 (*Berger, Kahn*).

[18] *McGee v. Superior Court* (1985) 176 Cal.App.3d 221, 226 (*McGee*).

[19] *Novak v. Low, Ball & Lynch* (1999) 77 Cal.App.4th 278, 282; Civ.Code § 2860(a).

[20] *James 3, supra*, 91 Cal.App.4th at 1108.

the liability case;"[21] and 9) "where the issue creating the conflict is one which must be decided in the underlying action."[22]

Some reported California opinions have attempted to collect the cases that have found that an insurer that reserves its rights *is required* to pay for independent counsel if each ground upon which the insurer may later deny coverage: "Some of the circumstances that may create a conflict of interest requiring the insurer to provide independent counsel include: (2) where the insurer insures both the plaintiff and the defendant; (3) where the insurer has filed suit against the insured, whether or not the suit is related to the lawsuit the insurer is obligated to defend; (4) where the insurer pursues settlement in excess of policy limits without the insured's consent and leaving the insured exposed to claims by third parties."[23]

"Conflicts [of interest] come in all shapes and sizes. The following list, by no means exhaustive, illustrates circumstances giving rise to a conflict: (1) counsel has divided loyalty between current client and former clients; (2) counsel has acquired a pecuniary interest which is adverse to the interests of the client; (3) unpaid fees to counsel may result in the sacrifice of important client rights; (4) there exists a romantic relationship between counsel and client; (6) client tells counsel that he intends to give perjured testimony at trial; (7) there has been an irreparable breakdown of the working relationship between counsel and client; (8) counsel plans to take on the role as a witness; (9) there have been settlement negotiations in which attorney's fees are recoverable apart from the amount sought for damages."[24]

Reported California opinions have found that a insurer that reserves its rights *is not required* to pay for independent counsel if the insurer reserves its rights to later deny coverage for the following claims: 1) "[a]n insurer's reservation of the right to seek reimbursement of defense costs;"[25] 2) "the damages are only partially covered by the policy;"[26] 3) the "complaint involv[es] covered and uncovered damages;"[27] 4) "[t]he reservation of rights is based on the resident relative exclusion in the policy;"[28] 5) there are "allegations of punitive damages"[29] provided the

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[21] *State Farm Fire & Cas. Co. v. Superior Court* (1989) 216 Cal.App.3d 1222, 1226, fn.3 (*State Farm Fire*).

[22] *Truck Ins. Exchange v. Superior Court* (1996) 51 Cal.App.4th 985, 994; see also, *Golden Eagle Ins. Co. v. Foremost Ins. Co.* (1993) 20 Cal. App. 4th 1372, 1395-1396 (*Golden Eagle*).

[23] *James 3, supra*, 91 Cal.App.4th at 1101 (citations and redundancies omitted).

[24] *Manfredi & Levine v. Superior Court (Barles)* (1998) 66 Cal.App.4th 1128, 1134-35 (citations, quotation marks, ellipses, and redundancies omitted).

[25] *Long, supra*, 163 Cal.App.4th at 1470; *James 3, supra*, 91 Cal.App.4th at 1108-1109.

[26] *Dynamic Concepts, Inc. v. Truck Ins. Exchange* (1998) 61 Cal.App.4th 999, 1007 (*Dynamic Concepts*); *Blanchard, supra*, 2 Cal.App.4th at 350.

[27] *Dynamic Concepts, supra*, 61 Cal.App.4th at 1007.

[28] *McGee, supra*, 176 Cal.App.3d at 227-228.

[29] Civ. Code § 2860(b).

insurer "will be liable for indemnification of compensatory damages;"[30] 6) "solely because an insured is sued for an amount in excess of the insurance policy limits"[31] unless settlement negotiations may impact the policyholder's personal exposure;[32] and 7) "a government demand to monitor and clean up pollution."[33]

Despite the multiplicity of nomenclature by which California courts have expressed the *Cumis* test, the courts have consistently applied the same basic legal test. In another context, the California Supreme Court observed that: "These shifting names have led counsel and the courts into confusion, thinking that they were dealing with different bodies of law. In fact, all these labels denominate the same basic legal claim."[34]

Reservation of Rights

A reservation of rights is typically a conditional denial of a third party plaintiff's claim for damages and the policyholder's first party claim for indemnification *and* a conditional acceptance of the policyholder's first party claim for a defense of the injured plaintiff's liability dispute. Typically, a reservation of rights letter states that the insurer will defend the policyholder but does not concede indemnity coverage and does not waive *any* ground upon which the insurer may later learn that it is entitled to deny all coverage.

California law has expanded the permissible scope of a reservation of rights to include two rights not mentioned in any standard policy that many neophytes find shocking: 1) a liability insurer may agree to pay for its policyholder's defense while reserving its rights to get back all of its costs of defense from its policyholder[35] and independent counsel[36]; and 2) an insurer may fund a settlement over the objection of its policyholder while reserving its rights to get back all of its costs of settlement from the policyholder.[37]

Insurance regulations require liability insurers to make a coverage decisions "immediately". "Upon receiving proof of claim, every insurer shall immediately, but in no event more than forty (40) calendar days later, *accept or deny the claim, in whole or in part*. Where an insurer denies a claim, in whole or in part, it shall do so in writing and shall provide to the [policyholder] a statement listing all bases for such denial and the factual and legal bases for each reason given for such denial which is then within the insurer's knowledge. Where an insurer's denial is based on a specific policy provision, the written denial shall include reference thereto and provide an explanation of the application of the provision to the claim."[38] A reservation of rights constitutes

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[30] *Wilks, supra*, 206 Cal.App.3d at 261.

[31] *Blanchard, supra*, 2 Cal.App.4th at 350.

[32] *Golden Eagle, supra*, 20 Cal.App.4th at 1396.

[33] *Federal Ins. Co. v. MBL, Inc.* (2013) 219 Cal.App.4th 29, 44 (ellipsis omitted).

[34] *Hartford Casualty Ins. Co. v. Swift Distribution, Inc.* (2014) 59 Cal.4th 277, 289.

[35] *Buss v. Superior Court* (1997) 16 Cal.4th 35 (*Buss*).

[36] *J.R. Marketing, supra*, 61 Cal.4th 988.

[37] *Blue Ridge Ins. Co. v. Jacobsen* (2001) 25 Cal.4th 489.

[38] Cal. Code Regs. § 2695.7(b)(1) (emphasis added, ellipses omitted).

a conditional acceptance of the claim for a defense and a conditional denial of the injured plaintiff's and the policyholder's shared claims that the insurer should pay the plaintiff's damages.

A reservation of rights always creates potential conflicts of interest and uncertainty. "[W]hen coverage is disputed, the interests of the insured and the insurer are always divergent."[39]

A reservation of rights always produces uncertainty in that it defers coverage decisions, usually until *after* the liability dispute is resolved. The process of resolving the plaintiff's liability claim may produce admissible evidence and judicial admissions[40] and apply the doctrines of "collateral estoppel", "res judicata", and "law of the case" that may impact the coverage issues upon which the insurer may deny coverage. A reservation of rights may seem relatively harmless in that it does not come right out and deny all coverage, it just defers until a later time a final decision whether to deny coverage.[41] Courts sometimes allow insurers to reserve their rights at almost any time, fostering uncertainty.[42]

Insurers tend to reserve their rights to later deny coverage "in a 'mixed' action, in which some of the claims are at least potentially covered and the others are not. [W]e justify the insurer's duty to defend the entire 'mixed' action prophylactically, as an obligation imposed by law in support of the policy. To defend meaningfully, the insurer must defend immediately. To defend immediately, it must defend entirely. It cannot parse the claims, dividing those that are at least potentially covered from those that are not. To do so would be time consuming. It might also be futile: The 'plasticity of modern pleading' allows the transformation of claims that are at least potentially covered into claims that are not, and vice versa."[43] Insurers often reserve their rights to later deny coverage in business litigation, construction defect, employment, pollution, and malpractice cases, as well as a wide variety of cases in which exclusions or other limitations on coverage may apply.

The *Cumis* Decision

In its two part "if-then" holding, the Cumis decision reasons that *if* an insurer's reservation of rights creates a conflict of interests between the insurer and the policyholder, *then* the insurer's lawyer must analyze potential conflicts of interest and disclose that analysis to both the insurer and the policyholder or the insurer must discharge its contractual promise to defend its policyholder by paying independent counsel to conduct the policyholder's defense of the injured plaintiff's tort lawsuit. A liability policy makes two primary promises: 1) to indemnify the policyholder for a judgment that is *actually covered* by the policy; and 2) to defend a lawsuit that is *potentially covered*. Because a liability insurer is not licensed to practice law, its promise to defend its policyholder creates an obligation that it cannot lawfully discharge by itself. Instead, the promise to defend necessarily creates a delegable duty to defend that must be discharged by

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[39] *Cumis, supra*, 162 Cal.App.3d at 375.

[40] See, *Res Judicata - Collateral Estoppel - Law of the Case* at DutytoDefend.com.

[41] See, *Acquiescence Is Dangerous* at DutytoDefend.com.

[42] See, *There Is No Deadline to Deny Coverage* at DutytoDefend.com.

[43] *Buss, supra*, 16 Cal.4th at 47-49 (citations and ellipses omitted).

paying a licensed attorney to conduct the policyholder's defense.[44] The insurer must defend immediately[45] and it must defend the entire action[46] by adequately funding the defense.[47]

The *Cumis* case summarized its holding by stating: [If, Part 1] "Canons of Ethics impose upon lawyers hired by the insurer 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 . . . , counsel must cease to represent both. [Then, Part 2] the insurer must pay the reasonable cost for hiring independent counsel by the insured."[48]

The Difference Between Independent and Dependent Counsel

*In*dependent counsel is a lawyer who has no relationship with the liability insurer and represents only the policyholder. In contrast, *de*pendent counsel is a lawyer who has a close relationship with the liability insurer and represents both the insurer and the policyholder. "In the insured-insurer relationship, the attorney characteristically is engaged and paid by the carrier to defend the insured. If the matter reaches litigation, the attorney appears of record for the insured and at all times represents him. In such a situation, the attorney has two clients."[49] "As a practical matter in reality, the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position, whether or not it coincides with what is best for the insured."[50] "[D]efense counsel and the insurer frequently have a

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[44] "Because insurance companies cannot themselves practice law, they must *delegate* their duty to defend to attorneys." (*Grissom v. Vons Companies, Inc*. (1991) 1 Cal.App.4th 52, 59). "By its very nature the duty assumed by [the insurer] to defend its assured against suits must necessarily be classified as a delegable duty, understood by all parties as such, for [the insurer] had no authority to perform that duty itself and, in fact, was prohibited from appearing in the California courts. (Bus. & Prof. Code § 6126.) Since a carrier is not authorized to practice law, it must rely on independent counsel for the conduct of the litigation." (*Merritt v. Reserve Ins. Co.* (1973) 34 Cal.App.3d 858, 880-81 (citations omitted).)

[45] "Imposition of an immediate duty to defend is necessary to afford the insured what it is entitled to: the full protection of a defense on its behalf." (*Montrose, supra*, 6 Cal.4th at 295.) "Upon receiving proof of claim, every insurer . . . shall immediately, but in no event more than forty (40) calendar days later, accept or deny the claim, in whole or in part." (Cal. Code Regs. § 2695.7(b).)

[46] "[T]he insurer has a duty to defend the action in its entirety." (*Buss v. Superior Court* (1997) 16 Cal.4th 35, 48.)

[47] "By definition, the duty [to defend] entails the rendering of a service, viz., the mounting and funding of a defense." (*Aerojet-General Corp. v. Transport Indemnity Co.* (1997) 17 Cal.4th 38, 58.)

[48] *Cumis, supra*, 162 Cal.App.3d at 375.

[49] *American Mut. Liab. Ins. Co. v. Superior Court* (1974) 38 Cal.App.3d 579, 591-92 (ellipses omitted.)

[50] *Purdy v. Pacific Automobile Ins. Co.* (1984) 157 Cal.App.3d 59, 76.

longstanding, if not collegial, relationship."[51] "Insurance companies hire relatively few lawyers and concentrate their business. A lawyer who does not look out for the Carrier's best interest might soon find himself out of work."[52]

The Rationale of the Cumis Rule

A reservation of rights constitutes a denial of coverage. Again, "[w]hen coverage is disputed, the interests of the insured and the insurer are always divergent."[53] Because dependent counsel has a longstanding, collegial, financially rewarding relationship with the reserving insurer, "[e]ven 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."[54]

The California Supreme Court explains: "The *Cumis* decision held that where the insurer provides a defense, but reserves the right to contest indemnity liability under circumstances suggesting that the insurer's interest may diverge from that of its insured, a conflict arises between insured and insurer. In such circumstances, a single counsel cannot represent both the insurer and the insured unless the insured gives informed consent. Absent the insured's consent to joint representation, the insurer must pay the insured's 'reasonable cost' for hiring independent counsel to represent the insured's litigation interests under the insured's control."[55]

"We begin by briefly reviewing the reason for Cumis counsel. An insurer is obligated to provide its insured with a defense to a third party's lawsuit when there exists a potential for liability under the policy. In this way, an insurer's duty to defend is broader than its duty to indemnify. Under these circumstances, an insurer may provide a defense under a reservation of rights, agreeing to defend, but promising to indemnify only for conduct covered by the policy. An insurer usually provides a defense to its insured by hiring competent defense counsel, who represents the interests of both the insurer and the insured. In some cases, there is a conflict of interest or a potential conflict of interest between the insurer and the insured. Usually, these conflicts involve the insured trying to obtain coverage and the insurer trying to avoid it. When this happens, defense counsel may not be permitted to represent both the insurer and the insured. The insurer may be required to provide the insured, at the insurer's expense, with independent counsel (i.e., Cumis counsel), who then controls the litigation."[56]

The rationales for this rule include that a reserving insurer lacks an economic incentive to launch a vigorous defense and dependent counsel owes fiduciary duties to the policyholder of undivided loyalty, disclosure and confidentiality.

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[51] *Berger, Kahn, supra* 79 Cal.App.4th at 131.

[52] *Cumis, supra*, 162 Cal.App.3d at 364.

[53] *Id.* at 375.

[54] *Union Ins. Co. v. Knife Co., Inc.* 902 F. Supp. 877, 880-81 (W.D. Ark. 1995) (*Knife*) (citations, quotation marks, and ellipses omitted).

[55] *J.R. Marketing, supra*, 61 Cal.4th 992, fn1.

[56] *Assurance Co. of America v. Haven* (1995) 32 Cal.App.4th 78, 83-84 (citations, quotation marks, and ellipses omitted).)

1. Vigorous Defense

"In actions in which the insurer lacks an economic motive for a vigorous defense of the insured, or in which the insurer and insured have conflicting interests, the insurer may not compel the insured to surrender control of the litigation."[57]

2. Duty of Undivided Loyalty

"[A]n attorney is precluded from assuming any relation which would prevent him from devoting his entire energies to his client's interests. The rule is designed to prevent the dishonest practitioner from fraudulent conduct, as well to preclude the honest practitioner from choos[ing] between conflicting duties."[58]

3. Duty of Disclosure

"The relation between attorney and client is a fiduciary relation of the very highest character. [Lawyers have] the obligation to render a full and fair disclosure to the [client] of all facts which materially affect his rights and interests and the non-disclosure itself is a 'fraud.'"[59] Dependent counsel has an affirmative duty to initiate disclosure of potential conflicts[60] that cannot properly be ignored.[61] "The potential for conflict requires a careful analysis of the parties' respective interests."[62] "There is no talismanic rule that allows a facile determination of whether a disqualifying conflict of interest exists."[63]

4. Duty of Confidentiality

"A member's duty to preserve the confidentiality of client information involves public policies of paramount importance. Almost without exception, clients come to lawyers in order to determine their rights and what is, in the complex of laws and regulations, deemed to be legal and correct. [I]n the absence of the client's informed consent, a member must not reveal information relating to the representation."[64] "[T]here may be confidences indulged by the insured to the attorney which in turn are not intended for the insurer."[65] "[W]here the carrier

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[57] *Tomerlin v. Canadian Indemnity Co.* (1964) 61 Cal.2d 638, 648 (emphasis added).

[58] *Anderson v. Eaton* (1930) 211 Cal. 113, 116 (citations and ellipses omitted.)

[59] *Neel v. Magana, Olney, Levy, Cathcart & Gelfand* (1971) 6 Cal.3d 176, 188-190 (citations, ellipses, and quotation marks omitted).)

[60] Dependent counsel "owed a duty to [the policyholder] . . . to disclose potential conflicts of interest between [the insurer and the policyholder]." (*Canton Poultry & Deli, Inc. v. Stockwell, Harris, Widom & Woolverton* (2003) 109 Cal App 4th 1219, 1224.)

[61] Dependent counsel's perfunctory denial of the existence of a conflict "was simply wishful thinking." (*Industrial Indem. Co. v. Great American Ins. Co.* (1977) 73 Cal. App. 3d 529, 535.)

[62] *Dynamic Concepts, supra*, 61 Cal.App.4th at 1007.

[63] *Berger, Kahn, supra*, 79 Cal.App.4th at 131, quoting *Dynamic Concepts, supra*, 61 Cal.App.4th at 1007-1008 (ellipses omitted).

[64] Rule 3-100, discussion (citations omitted.)

[65] *American Mut. Liab. Ins. Co. v. Superior Court* (*Nork*) (1974) 38 Cal.App.3d 579, 592.

questions the availability of coverage it is unavoidable that the insured's attorney will come upon information relevant to a coverage issue, it is impossible for the carrier's attorney to represent the insured (unless, of course, the insured consents)."[66]

Cumis Is Rooted In Legal Ethics

"The mandatory rule of disqualification in cases of dual representations involving unrelated matters - analogous to the biblical injunction against 'serving two masters' (Matthew 6:24) - is such a self-evident one that there are few published appellate decisions elaborating on it."[67] "The obligation of an insurer to provide independent Cumis counsel for an insured is premised on the ethical inability of an attorney to represent conflicting interests."[68] Ethical obligations pursuant to Rule 1.7 ripen when the potential exists for dependent counsel to control any coverage issue.[69]

Cumis In Context of the Majority "Per Se" Rule

About two-thirds of other jurisdictions have adopted an automatic "per se" rule that all reservations of rights compel a reserving insurer to forfeit control of the policyholder's defense because the insurer lacks an economic incentive to launch a vigorous defense. An exhaustive survey of American jurisdictions is available here that collects the holdings of other states in the words of the various courts.[70] A sampling follows:

"When defending under a reservation of rights, other jurisdictions have generally held that not only must the insured be given the opportunity to select his own counsel to defend the claim, the carrier must also pay the legal fees reasonably incurred in the defense. [T]here are various conflicts of interest between the insurer and the insured. First, the insurer may offer only a token defense. Second, the insurer might conduct the defense in such a manner as to make the likelihood of a plaintiff's verdict greater under the uninsured theory. Third, the insurer might gain access to confidential or privileged information in the process of the defense which it might

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[66] *Rockwell Internat. Corp. v. Superior Court* (1994) 26 Cal.App.4th 1255, 1263-1264 (*Rockwell*) (citation omitted).

[67] *Flatt v. Superior Court* (1994) 9 Cal.4th 275, 286; "No one can serve two masters. Either you will hate the one and love the other, or you will be devoted to the one and despise the other." (Matthew 6:24).

[68] *United Pac. Ins. Co. v. Hall* (1988) 199 Cal. App. 3d 551, 556; see also, "[T]he Cumis rule is not based on insurance law but on the ethical duty of an attorney to avoid representing conflicting interests." (*Golden Eagle, supra*, 20 Cal. App. 4th at 1394.) "Cumis is based on ethical standards, not on insurance concepts." (*Mosier v. S. Cal. Physicians Ins. Exch.* (1998) 63 Cal. App. 4th 1022, 1042.) "The Cumis opinion was based heavily on the canons of ethics and the possibly conflicting choices confronting an attorney." (*Blanchard, supra*, 2 Cal.App.4th at 350.)

[69] *Blanchard, supra* 2 Cal.App.4th at 350 ("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.")

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later use to its advantage in litigation concerning coverage."[71]

"Any lawyer who attempts to represent two adverse masters places himself in a precarious, perilous position. [Rules of ethics] are distilled principles of ancient, time-honored, and judicially-enforced conduct on the part of lawyers in representing clients. Without them our system of justice would be doomed. It hardly needs to be added that no insurance policy can validly diminish a lawyer's duty to his insured client. In sum, the ethical dilemma thus imposed upon the carrier-employed defense attorney would tax Socrates."[72]

A reservation of rights "disqualifies the insurance company from defending a suit against the assured for the recovery of damages which the insurance company says is not covered by its policy. In the very nature of things, could it be expected of the [policyholders] that they would further entrust the defense of their damage cases to attorneys employed by the insurer? We think not, especially in view of the Canons of Professional Ethics, the design of which canons was to guide the members of the legal profession and to protect the rights of litigants in their relations with legal representatives."[73]

Civil Code § 2860

"The Cumis opinion was codified in 1987 by the enactment of Civil Code section 2860, which 'clarifies and limits' the rights and responsibilities of insurer and insured as set forth in Cumis."[74] However the statute "does not clearly state when the right to an independent counsel vests."[75] Instead, the statute merely enunciates the obvious without providing any guidance: "If a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured. [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." This language has been interpreted to be a mere "example of a conflict of interest which may require appointment of independent counsel."[76] As described at length above, California courts have described dozens of other circumstances that may create a disqualifying conflict of interest.

Additionally, the code does *not* apply absent a judicial determination or the unconditional

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[71] *Moeller v. American Guar. & Liab. Ins. Co.* 707 So.2d 1062, 1069 (Miss. 1996) (citations, quotation marks, and ellipses omitted).

[72] *Hartford Acc. & Indem. Co. v. Foster* 528 So.2d 255, 269, 274 (Miss. 1988).

[73] *Hawkeye Cas. Co. v. Stoker*, 48 N.W.2d 623, 631-32 (Neb. 1951) (citations, quotation marks, and ellipses omitted).

[74] *James 3, supra*, 91 Cal.App.4th at 1100 (citation omitted); see also, *Seltzer v. Barnes* (2010) 182 Cal.App.4th 953, 966 ("Civil Code, section 2860 codifies (with clarifications and limitations) the holding in [*Cumis*], which concluded that an insurer is responsible to pay the reasonable cost for hiring independent counsel for the insured when the insured and insurer have divergent interests due to the insurer's reservation of its right to deny coverage"); *Long, supra*, 163 Cal.App.4th at 1470.

[75] *Dynamic Concepts, supra*, 61 Cal.App.4th at 1007.

[76] *Gafcon, supra*, 98 Cal.App.4th at 1421.

agreement of the insurer and the policyholder that the insurer has a duty to defend and that a disqualifying conflict of interest exists.[77]

The Harmonious or Dissonant Tripartite Relationship

When the insurer concedes coverage, the resulting harmony is analogous to the spirit of the Three Musketeers: "All for one and one for all." But, if conflicts of interest erupt between the policyholder and the insurer which reserves its rights to deny coverage, discord may undermine the harmony of the defense team. The "one for all" spirit may dissolve into a free-for-all. When conflicts of interest emerge the tripartite relationship is "torn and shredded".[78]

In the so called tripartite relationship, "[c]onceptually, each member of the trio, attorney, client-insured, and client-insurer has corresponding rights and obligations founded largely on contract, and as to the attorney, by the Rules of Professional Conduct as well. The three parties may be viewed as a loose partnership, coalition or alliance directed toward a common goal."[79]

However, every California reported opinion that has discussed the tripartite relationship recognizes that it works harmoniously only so long as there is not conflict of interest among the three participants: "absent a conflict of interest - [s]o long as the interests of the insurer and the insured coincide";[80] "[i]n the absence of a conflict of interest between the insurer and the insured";[81] "[s]o long as the interests of the insurer and the insured coincide";[82] "does not raise or reserve any coverage dispute, and where there is otherwise no actual or apparent conflict of interest between the insurer and the insured";[83] "the insurer's attorneys may have closer ties with the insurer and a more compelling interest in protecting the insurer's position [which] frequently gives rise to conflicts of interest between the insurer and its insured";[84] "[s]o long as the interests

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[77] *Handy v. First Interstate Bank* (1993) 13 Cal.App.4th 917, 926 ("in the absence of a stipulation or unconditional agreement between the insurer and insured, unless and until there has been a judicial determination of an insurer's duty to defend and the existence of a conflict of interest, the provisions of Civil Code section 2860 are inapplicable"); Several California appellate opinions have reached the issue, and they have all decided the issue the same way. See, *Janopaul K Block Cos., LLC v. Superior Court* (2011) 200 Cal.App.4th 1239, 1249; *The Housing Group v. PMA Captial Insurance Co.* (2011) 193 Cal.App.4th 1150, 1157; *Intergulf Development LLC v. Superior Court* (2010)183 Cal.App.4th 16, 20; *Atmel Corp. v. St. Paul Fire & Marine Ins. Co.* (N.D.Cal. 2005) 426 F.Supp.2d 1039, 1047.

[78] "The situation has changed. Partners have become adversaries. The closely knit fabric of confidentiality is torn and shredded." (*Nork, supra*, 38 Cal.App.3d at 593.)

[79] *Gafcon, supra*, 98 Cal.App.4th at 1407.

[80] *Id.* at 1406.

[81] *State Farm Auto. Ins. Co. v. Federal Ins. Co.* (1999) 72 Cal.App.4th 1422, 1429.

[82] *National Union Fire Ins. Co. v. Stites Prof. Law Corp.* (1991) 235 Cal.App.3d 1718, 1727.

[83] *Unigard Ins. Group v. O'Flaherty & Belgum* (1995) 38 Cal.App.4th 1229, 1236-37.

[84] *Bogard v. Employers Casualty Co.* (1985) 164 Cal.App.3d 602, 609 (ellipsis omitted.)

of the insurer and the insured coincide."[85] "The insurance defense attorney is placed in a position of conflict, however, when issues of coverage are asserted by the insurer through a reservation of rights. The possibility that the interests of the insured may become adverse to those of the insurer, and thus to those of the insurer's attorney, is exactly the reason Cumis counsel exists."[86]

Practice Pointer

Many courts, lawyers, policyholders, and plaintiffs have struggled unnecessarily to recognize when the right to independent counsel vests. At bottom, California has only slightly modified the automatic "per se" rule followed by a majority of other jurisdictions. The California rule is: "[W]hen the reservation of rights is based on coverage disputes that have nothing to do with the issues being litigated in the underlying action there is no conflict of interest, an, d no duty to appoint independent counsel."[87]

Overcoming confusion as to when the right to independent counsel vests is a little like playing three dimensional chess, a modern version of the ancient Persian game simulating war, in that each has three separate venues. In three dimensional chess, the pieces may move freely among three separate checker boards, while the right to independent counsel traverses three separate quarrels, each governed by a different set of laws: 1) tort law governs the liability dispute by the injured plaintiff against the policyholder; 2) contract law governs the coverage contest by the insurer against the policyholder; and 3) Rules of Professional Conduct, Rule 1.7 governs the ethical imbroglio by dependent counsel against the policyholder. Applying the wrong set of laws in the wrong venue is an error that has lead to some confusing published opinions.

A reserving insurer's obligation to pay for independent counsel is *derivative* of dependent counsel's ethical ban against representing dual clients with conflicting interests without analysis, disclosure, and informed written consent. Again, the two part "if-then" holding of the Cumis opinion is that: 1) *if* dependent counsel cannot ethically represent dual clients with conflicting interests; 2) *then* the insurer must pay for independent counsel.

This confusion has lead to two irreconcilable lines of authority in California. The *Cumis* line of cases focuses on Canons of Ethics to conclude that "lawyers hired by the insurer 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."[88] The *Dynamic Concepts* line of cases focuses on the terms of the policy contract and the complete lack of evidence of any conflicts of interest to conclude that a "mere possibility of an unspecified conflict does not require independent counsel. The conflict must be significant, not merely theoretical, actual, not merely potential."[89] Rule 1.7 requires lawyers to analyze "potential" conflicts of interest[90], make written disclosure to and obtain informed written consent from the policyholder. No one can

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[85] *Kroll & Tract v. Paris & Paris* (1999) 72 Cal.App.4th 1537, 1542.

[86] *Id.* at 1543.

[87] *Long, supra*, 163 Cal.App.4th at 1470 (citation omitted).

[88] *Cumis, supra* 162 Cal.App.3d at 375.

[89] *Dynamic Concepts, supra*, 61 Cal.App.4th at 1007.

[90] See, *Distinction Between Potential and Actual Conflicts of Interest* at DutytoDefend.com.

know whether a conflict of interest is merely "potential" or "actual" until someone has analyzed the circumstances. The burden of such analysis falls to the lawyer, not the policyholder - client. "[A] distinction between 'potential' and 'actual' conflicts of interest which is invalid and unworkable."[91] The "significant, not merely theoretical, actual, not merely potential" standard of *Dynamic Concepts* has been applied to a liability insurer's contractual obligation to pay independent counsel, but it cannot apply to lawyer ethics. Policyholders seeking to require a liability insurer to pay for independent counsel should challenge the ethics of dependent counsel, not the contractual obligation of the insurer. The insurer's contractual standard is stricter that the lawyer's ethical standard. *If* dependent counsel fails to resolve ethical conflicts, *then* the insurer must pay for independent counsel.

[91] *Cumis, supra*, 162 Cal.App.3d at 371, fn.7.