The Right to Independent Counsel in a Nutshell

Liability Insurance Basics

Liability insurance finances resolution of tens of millions of civil liability claims annually in the United States by exonerating policyholders from fault, settling disputes, or paying judgments. Like banks, liability insurers are financial institutions that primarily collect money, invest it for as long as possible, and figure out how to pay some of it back. Liability insurers make two primary contractual promises to their policyholders: 1) to pay a lawyer to guide the policyholder through the litigation process, known as the duty to defend; and 2) to pay a covered final judgment in the lawsuit, known as the duty to indemnify. Virtually all of the action, time, and complexity of adjusting a claim occurs during the duty to defend phase. In contrast, the duty to indemnify is usually completed, if at all, in a matter of seconds by simply cutting a check.

Strangely, because liability insurers are not licensed to practice law, they cannot lawfully keep their promise to defend their policyholders all by themselves. Instead, they must pay a lawyer to do the actual work of providing a defense of a lawsuit filed against the policyholder. This irony shifts the focus of the defense from the insurer to the lawyer.

Conflicts of Interest Between Insurer and Policyholder

But the first thing that all liability insurers do when they are asked to defend a third party claim is to analyze whether the claim is covered by the policy. At the outset, only three conclusions are possible: 1) "Yes", "No", and "Maybe". Increasingly, insurers say "Maybe" by issuing what is known as a reservation of rights. A reservation of rights is a warning from the insurer to its policyholder that: 1) it will advance funds to pay for its policyholder's defense; but 2) it may not indemnify the policyholder for a judgment or settlement - depending upon what happens in the future. Reservations of rights create tension between the insurer and the policyholder over control the defense of the lawsuit because the one in charge may be able to influence a conclusion that the lawsuit is covered, not covered, or a bit of both.

A reservation of rights always creates some kind of conflict of interest between the liability insurer and its policyholder in that each wants the other to pay. The insurer stands to benefit by facts and law developed during the defense that establish non-covered liability, while the policyholder will benefit if any liability is established, it is covered by insurance. Of course, the lawyer who actually conducts the defense may be able influence how the case comes out, and therefore, who must pay - the insurer, the policyholder, or both.

Conflicts of Interest for Dependent Counsel

It should be obvious that the conflicts of interest created by a liability insurer's reservation of rights present an ethical dilemma for lawyers hired by the insurer to protect both the insurer and the policyholder. This conflict is of Biblical origin: "No man can serve two masters." (Matthew 6:24.) Any lawyer representing both the insurer and the policyholder develops her/his own conflict of interest regarding which client to favor. Insurers regularly hire the same lawyers to conduct a policyholder's defense. These lawyers in turn depend upon liability insurers for most or all of their income, and thus are here called **de**pendent counsel. Naturally, such counsel's dependency on insurers for their livelihood often creates a strong temptation to favor the insurer over the policyholder, since the latter will likely never pay the lawyer a single dime.

Dependent counsel's ethical obligations are governed by Canons of Ethics known as Rules of Professional Conduct. Rule 1.7 requires all lawyers to: 1) analyze potential conflicts of interest between the insurer and its policyholder; 2) make written disclosure of the analysis to both clients; and 3) perhaps obtain their informed written consent to representation if a conflict of

interest between the insurer and the policyholder creates a disqualifying conflict of interest for the lawyer. A disqualifying conflict of interest is one that ethically bars dependent counsel from conducting the policyholder's defense.

No Conflicts of Interest for Independent Counsel

In contrast, **in**dependent counsel is selected and directed by the policyholder only and thus does not face the same ethical dilemma as dependent counsel. Independent counsel have no attorney-client relationship with the insurer, are not subject to the insurer's control, and do not represent the insurer's interests. But independent counsel do have an attorney-client relationship with the policyholder, are subject to the policyholder's control, and do represent only the policyholder's interests, while being paid by the insurer.

If dependent counsel has a disqualifying conflict of interest, the insurer must pay for independent counsel, which many insurers view as a bad thing. Independent counsel may charge more than dependent counsel and may influence the conduct of the defense into coverage, not out of coverage. Thus, it is often in the interests of insurers and dependent counsel to resist any determination that a disqualifying conflict of interest exists. Some irresponsible liability insurers and unethical dependent counsel mislead the policyholder about whether a disqualifying conflict of interest exists - usually by simply not telling the policyholder any of what you just read or disclosing any of law that can be found here at this website.

Three Different Rules Among Jurisdictions

Determining whether a disqualifying conflict of interest exists is a big deal. Various American jurisdictions follow one of three rules to make this determination.

- **The "Per Se" Rule**: Two-thirds of American jurisdictions follow the "per se" rule that **all** reservations of rights create disqualifying conflicts of interest and require all liability insurers to always pay for independent counsel to control the policyholder's defense.
- **The "Enhanced Duties" Rule**: A few states follow the "enhanced duties" rule that reserving insurers may control their policyholder's defense through dependent counsel so long as both the insurer and dependent counsel comply with enhanced duties of ethical standards and good faith. The policyholder may resist insurer control of the defense by demonstrating that a disqualifying conflicts of interest exists or that the insurer and/or dependent counsel have not fulfilled there "enhanced duties."
- **The Cumis Rule**: California and a growing number of jurisdictions have adopted the Cumis Rule that the insurer must pay for independent counsel only if the reservations of rights create a disqualifying conflict of interest for dependent counsel pursuant to the Cumis Test. The Cumis Rule requires somebody to do something to figure out whether a disqualifying conflict of interest exists by implementing what is here called the Cumis Test.

In the landmark *Cumis* case, the court found that a disqualifying conflict of interest existed and concluded that: "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. Moreover, . . . where there are divergent interests brought about by the insurer's reservation of rights, . . . 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." (*San Diego Navy Fed. Credit Union v. Cumis Ins. Society, Inc.* (1984) 162 Cal.App.3d 358, 375.)

The test for whether a reservation of rights creates a disqualifying conflict of interest for dependent counsel has developed in California over three decades through legislation and

published court opinions into what is here called the Cumis Test, which is: Insurers must pay for independent counsel only if each basis upon which the insurer has reserved its rights to later deny indemnity coverage have "**nothing to do with**" disputed facts or law to be decided in the injured plaintiff's liability dispute. Again, Rule 1.7 requires dependent counsel to: 1) always analyze potential conflicts of interest created by an insurer's reservation of rights; 2) always make written disclosure of the analysis to the policyholder and the insurer; and 3) sometimes obtain both clients' informed written consent.