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What We Have Here is a Failure to Communicate: Reservations of Rights, Independent Counsel, and Bad Faith

When an insurer reserves its rights on a coverage issue, the insurer may be required to offer the insured independent—or *Cumis*—counsel. The insurer's obligation to offer independent counsel will turn on the laws of the applicable jurisdiction and the circumstances surrounding the reservation.

Often, controlling the defense is important to the insurer, so it may not wish to cede that control to the insured. The insurance professional needs to understand the rules regarding independent counsel and how to navigate those rules in order to best achieve its objectives.

I. The Basis for Independent Counsel

A. The Insurer Generally Has the Right to Control the Defense

Where a liability policy provides that the insurer has the right and duty to defend, the insurer has the right to select defense counsel for its insured and control the defense. As part of its duty to defend, the insurer must provide a full defense by competent counsel. That defense counsel must be able to provide the insured with an "unconflicted" defense. Sometimes, a conflict may arise based on the nature of the claim. For example, the insurer insures several insureds who have conflicting claims against each other. The insurer must be careful about hiring a single defense counsel to represent several insureds. An insurer's duty to defend may be breached with the insurer selects defense counsel who may be placed in a conflicted situation.

B. The Tripartite Relationship

Another area where a conflict may arise is where the insurer reserves its rights. This issue generally relates to those situations in which the jurisdiction recognizes the

tripartite relationship, in which insurer-appointed defense counsel is deemed to represent the insured and the insurer.

C. Reservations of Rights

Because the insurance policy may have exclusions or other coverage defenses that ultimately could preclude coverage, a defending insurer may wish to reserve its rights to decline to pay for a judgment or part of a judgment that is not covered by the policy. Where the third party complaint against the insured asserts both covered and noncovered claims, the insurer should evaluate whether the right to independent counsel arises.

When the insurer provides a defense subject to a reservation of rights and the outcome of the coverage dispute can be affected by the manner in which the case is defended, the insurer may be obligated to offer the insured independent, or *Cumis*, counsel. Thus, the insurer may need to offer independent counsel for the insured when resolution of some issue in the lawsuit between the third party and the insured will bear directly on the outcome of the coverage dispute between insurer and insured. Given the reservation, the thought is that insurer-appointed defense counsel may have the incentive to shape the defense to the insured's coverage detriment. A key issue in determining whether the insured may be entitled to independent counsel is whether the liability action can be defended in such a way to affect the outcome of the coverage determination.

D. Not Every Reservation Creates an Obligation to Provide Independent Counsel

Not every reservation of rights requires the insurer to provide independent counsel for the insured. The fact an insurer defends under a reservation of its right to deny coverage does not, by itself, create a conflict entitling the insured to select independent counsel. Nor does an insurer's general reservation of rights create the right to independent counsel. Where the insurer has not expressly reserved its right to deny coverage under a particular exclusion in its policy, there can be no actual conflict based on the application of that exclusion during the pendency of the action.

A case-by-case analysis is required. An independent counsel conflict requires that the interests of the insured and the insurer diverge regarding the manner in which defense counsel may conduct the insured's liability defense. The rationale is that the insurer—and its appointed defense counsel—has an incentive to defend the liability action to avoid coverage, even if so doing pins liability on the insured; by contrast, the insured has an incentive in ensuring that it has coverage for the claims against it, even if it may be liable for those claims.

The conflict must be significant, not merely theoretical, actual, not merely potential. In determining whether a conflict exists, the court must analyze the parties' respective interests determine if they can be reconciled or if there is a conflict of interest which puts appointed counsel in the position of having to choose whether to serve the insured's or insurer's interest.

E. "Courtesy" Defense

Sometime, insurers may extend a "courtesy" defense to an uninsured party that is a co-defendant with the insured to present a united front against the plaintiff. In those situations, the insurer will not have a duty to indemnify the uninsured party, and the incentive may exists for insurer-appointed defense counsel to steer the defense such that the uninsured defendant is liable, but the insured defendants are not. Because of that, the insurer should consider allowing the uninsured co-defendant to select its own counsel to avoid any claim from that party.

F. Investigating the Conflict

Assuming no action is required in the underlying action that could implicate a potential conflict, an insurer generally should have the opportunity to perform a good faith investigation to determine whether it needs to provide the opportunity to the insured to select independent counsel. Any investigation should be done promptly to avoid any issues regarding the provision of a defense to the insured.

II. Considerations Regarding whether to Appoint Independent Counsel

The insurer may wish to maintain control over the defense. The insurer should recognize those situations that do not create an independent conflict and ways to address conflicts that actual may exist.

A. No Conflicts

Often, an insured or its coverage counsel may assert that an independent counsel conflict exists where it does not. The claims professional needs to recognize these situations so that he or she does not appoint counsel where so doing is not required.

1. Coverage Dispute Not at Issue in the Underlying Action

An independent counsel conflict does not exist where the coverage dispute is not at issue in the underlying action. If a reservation relates to coverage issues that will not be decided in the underlying action, insurer-appointed defense counsel cannot control that action to the insured's coverage detriment. Independent counsel is not required.

2. The Insured's Declaratory Relief Complaint Does Not Create an Independent Counsel Obligation

Where the insured is being defended by insurer-appointed counsel brings a declaratory relief action against the insured, that does not create a conflict requiring the insurer to offer independent counsel. Otherwise, the insured could get independent counsel in any action merely by asserting a coverage dispute.

3. The Insurer and Insured Share an Interest in Defeating Liability

The key issue in determining whether a conflict exist is to determine whether the insurer and insured share an interest in defeating liability. For example, where a reservations on an issue such as whether the claim falls within a policy period does not create a situation where both the insurer and insured share an interest in defeating coverage. No conflict exists in those situations.

B. Avoiding Independent Counsel or Bad Faith where a Conflict Exists

Assuming that an independent counsel conflict exists, the insurer may take steps to avoid the conflict and proceed with appointed counsel. In evaluating its options, the insurer should determine the ramifications of its choices in terms of being able to assert its coverage defenses and weigh those against the ability to select counsel. Communication may be key in deciding how best to proceed.

1. Obtaining the Insured's Waiver to Select Counsel

One way to avoid independent counsel is to get the insured to waive its right to independent counsel. Often, insureds may not know of counsel that can defend its interests. In those situations, the insured may be willing to waive their right to have independent counsel. This may be more easily done where the insured has had a prior relationship with insurer-appointed defense counsel. This may be a good first step in avoiding the need to appoint independent counsel.

Where the insured has agreed to waive counsel, the insurer should always get the insured's waiver in writing.

2. Withdraw the Conflicting Reservation

Sometimes, the issue on which the insurer reserves its rights will not have a significant impact on whether the insurer ultimately will pay for claims under the policy. For example, where the issues involves the insured's knowledge, but that issue will not determine whether the insurer ultimately will pay for any judgment or settlement, the

insurer may wish to withdraw any reservation on "occurrence" or the expected or intended defense.

required: "The potential for conflict requires a careful analysis of the parties' respective interests to determine whether they can be reconciled (such as by a defense based on total nonliability) or whether an actual conflict of interest precludes insurer-appointed defense counsel from presenting a quality defense for the insured."
There was no basis to presume a conflict of interest where the insurer (i) waived its contractual right to control the defense; (ii) ceded control to the insured's personal attorney; and (iii) offered to appoint other counsel to sit as second-chair whose only role was to defend the insured, not represent the insurer.

3. Instruct Insurer-Appointed Defense Counsel to Ignore the Coverage Issues

A question exists whether the insurer can avoid the independent counsel issue by instructing defense counsel to disregard coverage issues in defending the third party action. At least one case has held that where the insurer provides such an instruction, defense counsel is "not subject to the conflicting forces which gave rise to *Cumis*." *Native Sun Invest. Group v. Ticor Title Ins. Co. of Calif.*, 189 Cal.App.3d 1265, 1277-1278 (1987) (finding no conflict where the insurer instructed appointed defense counsel to litigate the underlying action without regard to the insurance coverage issues).

A question for the insurance professional is whether he or she provides its coverage position letter to the insured. In those situations where the insurer wishes to instruct defense counsel to disregard coverage, the insurer, if possible, should not share the coverage position letter.

If the insurer wishes to take this approach, he or she should understand the risks involved. Even in California, where the *Native Sun* case was decided, such an instruction likely would not be sufficient to insulate the insurer from its obligation to provide the insured with the opportunity to select independent counsel. An insured likely would assert that despite such instruction, insurer-appointed counsel still sought to place the insurer's interests above the insured's in defending the litigation.

4. Continue with Insured-Selected Counsel

Sometimes, the insured will select competent counsel for the defense and an option for the insurer may be to continue with that counsel. One issue this can present is the rates that insured-selected counsel charges. If those amounts are above what the insurer normally pays, the insurer may be able to negotiate with the insured to pay normal rates and the insured to pay the difference.

Another approach may be to allow the insured to maintain its counsel and hire defense counsel to associate in and/or monitor the case.

III. Communication Is Critical

In addressing independent counsel issues, communication between the insurer and various others—including the insured, insured-appointed defense counsel, and insurer-appointed defense counsel—may be key in ensuring that those issues can be addressed in a manner that is favorable to all involved. In that regard, if an accommodation can be reached with the insured on independent counsel issues, that accommodation should be documented to ensure that there are no misunderstandings.