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Managing Conflicts of Interest in Eroding Limits Policies

I. The Assignment of Defense Counsel

When an insurer agrees to defend its insured, the insurer must decide whether to assign panel counsel, or allow the insured to designate its chosen counsel to defend the claim at the expense of the insurer. This decision is usually dictated by whether the reservation of rights letter issued by the insured creates a potential conflict of interest between the insurer and the insured. That decision can have significant consequences not only on how the case is defended, but the costs of defending the insured.

Where the policy that is affording the defense contains eroding limits, the interests of the insurer, the insured, and defense counsel may not be completely aligned throughout the life of a claim. All three generally have a shared interest in vigorously defending the claim, preserving policy limits and finding the right resolution for the insured. But finding that right resolution is not always easy, and disagreements can arise throughout the life of a case as to how to navigate the defense in the best interests of the insured while respecting the rights of the insurer.

II. Defense Counsel Rates and Guideline Compliance

Panel counsel firms are firms that have an established relationship with an insurer such that the insurer uses the firm repeatedly for a particular type of case in a specific jurisdiction. Panel firms usually agree to certain rates in order to maintain good favor with insurer clients while still offering high quality of work and good results for the insureds they represent. Those insurance defense rates have traditionally been lower than the rates charged by firms that are not routinely retained by insurance carriers (*i.e.* independent counsel).

When an insured is given the right to select independent defense counsel to be paid by the insurer, the result is often that the rates being charged are much higher than the rates the insurer usually pays to its panel counsel. The delta between panel firms and non-panel firms seems to have grown significantly more recently, creating more challenges in preserving policy limits when independent counsel is involved.

Moreover, the way that the defense of a case is staffed by the defense firm can also create strife between the insurer and the insured. Typically, insurers prefer to see one partner and one associate handling the defense of a claim, unless the complexity of the claim requires more attorneys to participate in the defense. Limiting the amount of attorneys on a file can avoid duplication of efforts, reduce unnecessary internal conferences, eliminate the cost of paying for younger attorneys to train on the job, and promote efficiency. When an insured wants to utilize

an independent counsel firm that will assign three or more attorneys to a file, there is a likelihood that the rate of erosion of policy limits will accelerate.

Another difference between panel counsel and independent counsel involves guidelines compliance. Those guidelines are created by insurers in order to ensure that the policy limits are being used efficiently. The insurer has significant experience defending all types of claims, and the guidelines are present so defense attorneys take the rights steps to preserve policy limits while zealously representing the policyholder.

The insurer therefore needs to address rates, staffing and guideline compliance at the outset of the claim. The insurer should remind the insured that it can better preserve its limits by negotiating a lower defense rate and reducing the number of attorneys working on a file, unless the circumstances warrant a different approach. Defense counsel can also be educated about how policy limits need to be preserved to benefit its client – the insured. This is not to say that an insurer will not pay for a defense firm that will properly defend a case. Rather, these safeguards help to avoid inefficiencies and encourage the preservation of policy limits for the claims asserted against the insured.

III. Strategies in Defending A Claim – The Role of Defense Counsel

There also may be discrepancies between how an insurer and insured determine the proper strategy in defending a claim. For example, identifying and retaining experts can be an important part of the defense, but it is also an expensive component of the costs in defending a claim. The insured and its defense counsel must identify the right experts that have the experience to advocate for the insured in a cost-efficient manner, and to make sure that experts are retained at the right stage of the proceedings. Figuring out when experts should be retained, or other costs incurred, is usually within the purview of defense counsel, but the insurer should also have a voice in that discussion.

Ultimately defense counsel needs to be in a position to make decisions that offer the best defense to its client – the insured. ABA Model Rule of Professional Conduct 1.2 requires a lawyer to abide by his or her client's decisions regarding their representation and whether to settle a matter. Specifically, 1.2 (a) states in part as follows:

> …a lawyer shall abide by a client's decisions concerning the objectives of representation and…shall consult with the client as to the means by which they are to be pursued. A lawyer may take such action on behalf of the client as is impliedly authorized to carry out the representation. A lawyer shall abide by a client's decision whether to settle a matter…

However, Rule 1.2 (c) allows a lawyer to reasonably limit the scope of the representation as long as the client gives informed consent. Comment 6 to Rule 1.2 specifically explains that, "[w]hen a lawyer has been retained by an insurer to represent an insured, for example, the representation may be limited to matters related to the insurance coverage."

The problem then becomes one of a more practical nature – how should this be done in the context of an insurance defense relationship? The best method of handling this issue is to address the limitation of the representation with both the insured and the insurer early on in the representation. One way to do this is for defense counsel to provide written notice to the insured that "the lawyer intends to proceed as directed by the insurer in accordance with the terms of the

insurance contract and what this means to the insured." In doing so, the lawyer must "make appropriate disclosures sufficient to apprise the insured of the limited nature of his representation" and what the limitations are specifically, since Rule 1.2 requires *informed* consent.

Despite the fact that Rule 1.2 allows an attorney to limit the scope of his or her representation and contemplates doing so in the context of the representation of an insured in the insurance defense context, the acceptability of this is seemingly contradicted by Rules 1.8(f) and 5.4(c). Rule 5.4(c) specifically states that "[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." Additionally, Rule 1.8(f) provides that a lawyer may only accept compensation from a third party as long as there is no interference with the lawyer's independent professional judgment and the client gives informed consent.

Of course, the ideal situation involves an insurer, insured, and defense counsel all working together in harmony to identify the right course to pursue in defending a claim. Insurers are rarely reluctant to invest costs and fees in the defense of a claim when the strategy promoted by defense counsel is sound and provides the insured with the best chance of a positive outcome.

IV. Settlement and Consent

The insurer and the insured have a mutual interest in finding the right result for the insured. Ideally that comes with no payment from the defense side, perhaps because the plaintiff abandons the suit, or a dispositive motion is decided in favor of the insured. More often than not, however, the resolution of the claim comes in the form of a settlement.

The plaintiffs' bar has become well-educated in how to drive a wedge between the insurer and the insured through policy limits settlement demands. These demands often place the insured in a difficult position - choose to settle the case and either deplete or erode entirely its available insurance coverage, or continue to defend the claim and hope for a better result. The latter option may come with some risk, including the potential that the ultimate settlement or judgment of the claim will exceed the available insurance and require payment out of the insured's own pocket.

In that vein, insurers and insureds may find themselves in disagreement over whether the settlement demand should be accepted. Insureds may prefer to resolve the dispute and eliminate the risk of personal financial exposure. The insurer, conversely, may firmly believe that the claim does not justify payment of policy limits. The insurer may want to pursue settlement negotiations to reduce the settlement demand, or outright reject any settlement overtures. Meanwhile, defense counsel can be caught in the middle. The insured may press defense counsel to highlight the risk of an adverse verdict in excess of limits in order to encourage the insurer to accept the settlement, while the insurer may focus on the strengths of the defense to the claim in an effort to bolster its position that the demand should be rejected. In those situations, all parties should factor in the past and future depletion of policy limits in order to gauge whether the settlement demand reflect the liability facing the insured as well as the financial exposure facing the insurer and the insured.

The settlement dynamic can also become more complicated when the claim involves a professional liability policy that contains consent to settle and hammer clauses. Many professional liability policies give the insured the right to veto any settlement opportunity.

Professionals insist on such clauses to avoid any reputational damage that may come with the implication that a settlement acknowledges some wrongdoing. In that situation, and insured may

In response to that situation, some policies give an insurer ammunition to respond to an insured that refuses to consent to a settlement opportunity. Certain policies require that the insured's refusal be "reasonable." Other policies explain that where an insured refuses to consent to settle, an insurer can limit its exposure to the defense costs expended to date along with the amount of the settlement that could have been accepted. Often called "hammer clauses," these provision shift the risk of future loss on the insured, while preserving the insured's right to reject a settlement in order to continue to litigate the claim. Insurers should use these provisions in situations when there is a clear opportunity to settle the claim and the insured cannot be convinced that the settlement is the best result given the nature of the claim.

V. Communication and Collaboration

Communication and collaboration is usually at the core of a harmonious tripartite relationship. Ensuring that the insurer, insured, and defense counsel have a voice in the discussion at all stages of a claim offers the best opportunity to preserve policy limits while advocating for the insured in defense of a claim.