

Is Three Company Or A Crowd? Conflicts And The Tripartite Relationship

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IS THREE COMPANY OR A CROWD? CONFLICTS AND THE TRIPARTITE RELATIONSHIP¹

1. AN INTRODUCTION TO THE TRIPARTITE RELATIONSHIP

The tripartite relationship is the relationship between the defense lawyer, the insurer, and the policyholder that is created when the defense lawyer is hired by an insurer to defend a suit against the policyholder. In some jurisdictions, like Minnesota and Alabama, the policyholder and the insurer have been considered dual clients.² Other jurisdictions, like Arizona and California, consider the policyholder the “primary client,” implying that the lawyer has at least has a secondary obligation to the insurer.³ In Texas, Montana, Michigan, and Connecticut, the law is clear that the policyholder is the only client. *See Safeway Managing General Agency, Inc. v. Clark & Gamble*, 985 S.W.2d 166, 168 (Tex.App.-San Antonio 1998) (no attorney-client relationship exists between an insurance carrier and the attorney it hired to defend one of the carrier’s insureds); *Bradt v. West*, 892 S.W.2d 56, 77 (Tex.App.-Houston [1st Dist.] 1998); *State Farm Mut’l Auto Ins. Co. v. Traver*, 980 S.W.2d 625-27 (Tex.1998) (the attorney owes unqualified loyalty to the insured).⁴ This paper will provide guidance

¹ This paper was presented at the ABA Section of Litigation Insurance Coverage Litigation Committee CLE Seminar held in Tucson, AZ on March 4-7, 2009.

² *See e.g. Shelby Mut’l Ins. Co. v. Kleman*, 255 N.W.2d 231, 235 (Minn. 1977); *Mitchum v. Hudgens*, 533 So.2d 194, 198 (Ala. 1988).

³ *See e.g. Paradigm Ins. Co. v. Langerman Law Offices*, 24 P.3d 593, 602 (Ariz.2001)(although the insurer was not the “client,” the defense lawyer nonetheless owed a duty to the insurer); *State Farm Mut’l Auto v. Federal Ins. Co.*, 86 Cal.Rptr.2d 20 (1999).

⁴ Other jurisdictions like Montana, Michigan, and Connecticut also have held that the policyholder is the only client. *See e.g. In Re Rules of Professional Conduct and insurer Imposed Billing Rules and Procedures*, 2 P.3d 806 (Mont.2000); *Atlanta Int’l Ins. Co v. Bell*, 475 N.W.2d 294 (Mich.1991); *Metropolitan Life Ins. Co. v. Aetna Cas. & Sur. Cor.*, 730 A.2d 51 (Conn.1999).

on how to handle the conflicts that will inevitably arise when an insurer hires staff counsel or outside counsel to defend the insured.

2. ETHICAL GUIDANCE FOR NAVIGATING THE TRIPARTITE RELATIONSHIP: THE ABA MODEL RULES

In assessing counsel's duties and obligations in the tripartite relationship, ethical standards of professional conduct, such as the ABA Model Rules and state ethics rules, can serve as helpful guideposts. This section of the paper briefly sets forth several Model Rules of Professional Conduct relevant to the analysis and discusses their impact on key problems that arise in the tripartite relationship.⁵

a. A Fundamental Inquiry: Who is the Client?

The ABA Model Rules of Professional Conduct establish standards and limitations for attorneys vis a vis their clients in a variety of contexts. Among other things, the Rules explain an attorney's responsibilities to his or her client in making settlement decisions (Rule 1.2(a)), responding to client requests for information (Rule 1.4), soliciting client input about the status and progress of the case (Rule 1.4), maintaining client confidentiality (Rule 1.6), and safeguarding client property (Rule 1.15). Rules like these are relatively straightforward and easy to apply to the typical attorney-client relationship, where the roles of each party are clearly defined. They become much more complex, however, when an insurer hires counsel to defend a claim against its policyholder. In that instance, the attorney likely has been retained by the insurance company, who is paying his or her fee, and the attorney may have an ongoing relationship with the insurer as a member of a panel of insurer-approved firms. The attorney's work on the case, however, is performed directly for the benefit and on behalf of the policyholder, who often has the biggest interest and stake in the litigation, and whose interests frequently may diverge from that of the insurer. Given the significance of defense counsel's duties to its "client" under the ABA Model Rules and state ethical standards, determining who holds this status is a fundamental question with respect to the tripartite relationship.

Unfortunately, the Model Rules and their commentary do not provide clear guidance on this important initial inquiry, and recent ABA ethics opinions have declined to take an official stance on the matter. In ABA Formal Opinion 96-403, the ABA Standing Committee on Ethics and Professional Responsibility refused "to enter the debate as to whom the lawyer represents" in the tripartite relationship. ABA Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. 96-403 at 2 (1996) (hereinafter "ABA Opinion 96-403"). Instead, the Opinion notes that, "[p]rovided there is appropriate disclosure, consultation, and consent," a lawyer may represent the insured alone, the insured and the insurer, or the insured and the insurer, but only for certain limited purposes. *See id.* Likewise, ABA Opinion 01-421, which discusses the ethical obligations of a lawyer working under insurance company litigation guidelines, takes no position as to the identity of the client in the tripartite relationship. *See* ABA Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. 01-421, at 2 (2001) (hereinafter "ABA Opinion 01-421"). To further muddy the waters, judicial determinations of

⁵ This paper is designed to provide a broad overview of ethics rules relevant to the tripartite relationship. Specific application of these principles may differ by jurisdiction. For a listing of the sources of state ethics rules and opinions for your jurisdiction and a description of how they differ from the ABA Model Rules, *see* ABA/BNA LAWYER'S MANUAL ON PROFESSIONAL CONDUCT § 1:3. The DRI Ethics Task Force also has helpful state-specific information pertaining to the tripartite relationship on its website, www.dri.org. *See, e.g., A Survey of State Ethics Opinions Concerning the Tripartite Relationship*, DRI Ethics Task Force, July 2002.

this issue have varied, with some courts regarding both the insured and insurer as clients and others deeming the insured as the sole client.⁶

Significantly, one of the leading treatises on professional responsibility, the Restatement 3d of the Law Governing Lawyers, holds the view that “a lawyer designated to defend the insured has a client-lawyer relationship with the insured” and that “[t]he insurer is not, simply by the fact that it designates the lawyer, a client of the lawyer.” RESTATEMENT 3D OF THE LAW GOVERNING LAWYERS, § 134 at 408 (2000) (hereinafter “RESTATEMENT § 134”). According to the Restatement, the insurer may also be deemed the attorney’s client, but it does not attain this status by virtue of its selection and retention of defense counsel. Instead, this fact-specific inquiry is determined by reference to the general principles governing creation of the attorney-client relationship. *Id.*

Regardless of whether the attorney is deemed to represent only the insured or both insured and insurer, however, it is clear that counsel’s duties and obligations ultimately are governed by the Model Rules of Professional Responsibility and other relevant ethical standards, not the terms of the insurance contract. See ABA Opinion 96-403 at 2. Therefore, while the attorney must be mindful of requirements established by the insurer and/or the policy, these standards do not trump the lawyer’s responsibility to act in conformity with applicable ethical rules. The following section highlights certain of those rules particularly germane to attorney conduct in the tripartite relationship.

b. ABA Model Rule 1.6: The Duty of Confidentiality

Rule 1.6(a) of the Model Rules of Professional Conduct prohibits an attorney from disclosing information relating to his or her representation of a client, unless the client has given informed consent or the attorney has implied authorization to make the disclosure as part of the representation.⁷ Rule 1.8(f), which governs attorney compensation from third parties, makes clear that when a lawyer is paid by a source other than his or her client, client confidentiality is to be preserved in accordance with Rule 1.6. *See* Model Rule 1.8(f)(3). Given that insurance policies often accord the insurer contractual rights to exercise substantial control over the litigation, in many cases an attorney may disclose routine case information to the insurer without issue under the “implied authorization” exception to Rule 1.6. One such instance of implied authorization is disclosure of billing statements and periodic status reports. ABA Opinion 01-421 at 1.

However, both the ABA Standing Committee and the Restatement acknowledge that some disclosures of confidential information to the insurer may conflict with the best interests of the insured. The Restatement indicates unequivocally that “[i]nformed client consent to the third-person payment or direction does not by itself constitute informed consent to the lawyer’s revealing [confidential] information to that person.” RESTATEMENT § 134 at 407-08. Instead, the attorney should seek the insured’s informed consent under Rule 1.6 whenever the disclosure of information to the insurer may have an adverse effect on “a material interest” of the policyholder. ABA Opinion 01-421 at 5; *see* Rule 1.8(b) (prohibiting a lawyer from using information relating to the representation of a client to the

⁶ *See, e.g.*, ABA Standing Comm. on Ethics & Prof’l Responsibility, Formal Op. 01-421, at n.6-7 (2001) (providing examples of variation among jurisdictions).

⁷ A lawyer also is permitted to disclose confidential client information for one of the reasons specifically enumerated in Rule 1.6(b). *See* Rule 1.6(a) (stating the general rule); 1.6(b) (citing exceptions to non-disclosure to prevent death or substantial bodily harm, to prevent crime or fraud in certain instances, to secure legal advice about the application of the Model Rules, and to comply with laws or court orders).

client's disadvantage without the client's informed consent). For example, the attorney should obtain the insured's informed consent under this standard when the prospective disclosure may limit or preclude coverage under the policy, when the insured's trade secrets or other proprietary data is at issue, or when the disclosure includes irrelevant information of a sensitive or personal nature. In addition, the disclosure of any information that "implicates a conflict between the insurer and insured" should be considered as potentially adverse to the material interest of the insured client. ABA Opinion 01-421 at 7.

How does an attorney obtain an insured's "informed consent" to disclose potentially materially adverse information to the insurer? Under Rule 1.0(e), "informed consent" is an "agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct." The ABA/BNA Lawyers' Manual on Professional Conduct builds on this definition in the context of the tripartite relationship. It explains that counsel may need to discuss the potential effects of disclosure with his or her insured, which include a possible waiver of attorney client privilege if the insurer discloses the information to third parties and a possible breach of the duty of cooperation clause in the policy if the insured fails to provide the requested information. ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT § 51:323-24.

If the insured gives informed consent to the disclosure, the attorney should strive to safeguard client confidences, as well as the attorney-client privilege, by curtailing production of unnecessary information and by seeking assurances from the insurer that it will not release the insured's confidential information to third parties, such as auditors. *See id.*; ABA Opinion 01-421 at 8. If the insured does not consent to release information that may be materially adverse to its interests, then the attorney is faced with a conflict. In that case, the attorney should approach the insurer to determine whether the confidential information sought is truly required. If the insurer does not withdraw its request for the confidential information, the attorney reasonably believes that disclosure of that information may materially impact the insured, and the insured does not consent to its disclosure, the attorney may be forced to withdraw from the representation. *See generally* Rule 1.7 (governing conflicts of interest).

A good practice pointer for avoiding these issues is to decide and memorialize at the outset of the representation what types of information will be kept confidential from the insurer and what types of information the attorney will be implicitly authorized to disclose. While this approach may not preclude all conflicts under Rule 1.6, it may help to set expectations for both parties before difficult questions arise.

c. Model Rule 1.7: The Duty of Loyalty

Under Rule 1.7 of the Model Rules of Professional Conduct, an attorney shall not represent a client if the representation will create a conflict of interest. The Rule sets forth various scenarios in which a conflict may occur, including one in which "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to . . . a third person." Rule 1.7(a)(2) If a conflict of interest arises, the attorney must withdraw from the representation unless the conflict is one to which a client may validly consent under the requirements of Rule 1.7(b) and each affected client gives informed consent in writing. *See* Rule 1.7(b); Comment [4] to Rule 1.7.

With respect to conflicts in the tripartite relationship, the Restatement affirms that the lawyer should “proceed in the best interests of the insured . . . and, if applicable, consistent with the lawyer’s duties to the insurer as co-client.” RESTATEMENT § 134 at 410. Under Rule 1.7, if the lawyer cannot work under the direction of the insurer while still advancing the best interests of the insured, then the lawyer must withdraw from the representation. He or she may not abide by any insurer instructions that adversely and materially impact the insured. RESTATEMENT § 134 at 409-10; *see* Rule 1.8.

The lawyer may avoid potential conflicts of interest at the outset, however, by specifically delineating the scope of his or her representation as early as possible in the litigation. These types of limitations are expressly permitted under Rule 1.2(c). *See* Rule 1.2(c) (providing that “[a] lawyer may limit the scope of the representation” if the client consents after consultation). Examples of areas in which defense counsel should circumscribe its representation include, among other things, the nature and extent of the insured’s coverage, rights, and obligations under the policy; whether the insured could (and should) file claims against other insureds under its contract of insurance; and whether the insured has actionable claims against the insurer. *See* Restatement § 134 at 410. With respect to conflict-creating issues like these, the insured should be advised to retain conflicts counsel. *See id.* According to ABA Opinion 96-403, “[a] short letter clearly stating that the lawyer intends to proceed at the direction of the insurer in accordance with the terms of the insurance contract and what this means to the insured” is sufficient to make the insured aware of the scope of defense counsel’s representation. This correspondence clarifies the roles of each member of the tripartite relationship and may prevent problems that could arise if the insured forgot, misunderstood, or never read the terms of his insurance policy. *See* ABA Opinion 96-403 at 2. Once the attorney clearly advises the insured about the limits of the representation being offered, and the insured understands that the lawyer intends to follow the directions of the insurer, the insured can make an informed decision as to whether to accept the insurer’s defense or to assume responsibility for its own defense at its own expense. *Id.*

A clear statement of the defense counsel’s limitations, however, is not always the panacea for conflicts that arise in the tripartite relationship. Even if the insured accepts the representation of the lawyer selected and compensated by the insurer, there may be disagreements between the parties as to strategy and control of the litigation. One of the biggest conflicts arises during settlement negotiations. As discussed above, Rule 1.2 requires the lawyer to honor the client-insured’s decision on settlement. Under many insurance policies, however, the insurer has a contractual right to control the defense of the insured and to settle a claim without its consent. ABA Opinion 96-403 considers this tension in light of Rule 1.16, which establishes the client’s ultimate right to terminate the representation. The Opinion concludes that “[u]ltimately . . . although the insurer hires the lawyer and pays his fee, the insured retains the power to reject the defense offered by the insurer under the policy and to assume the risk and expense of his own defense.” ABA Opinion 96-403 at 3. Thus, if the attorney knows or has reason to know that the insured objects to a settlement that the insurer approves, the attorney should give the insured the opportunity to reject the defense offered and terminate the representation. If the insured decides to do so, the attorney cannot participate in the settlement on behalf of the insurer unless the insured consents. *See id.*; Rule 1.9 (governing duties to former clients).

Another conflict that arises in the context of the tripartite relationship concerns the insurer’s litigation guidelines. These requirements, which insurers frequently implement for cost-saving purposes, usually do not pose any significant problems with respect to the insured’s defense. When the insurer’s directives undermine the attorney’s independent judgment or materially limit his or her ability to effectively represent the insured, however, they create a conflict under Rule 1.7. At that point, the

defense attorney should approach both the insured and the insurer to determine how best to proceed. A principal way to resolve the conflict is to request that the problematic directive be modified or withdrawn. ABA Opinion 01-421, at 4. If the insurer refuses to do so, however, and the insured either cannot reasonably consent to the directive or refuses to consent, the attorney should seek to withdraw from his or her representation under Rule 1.7. *Id.*

The duty of loyalty also is implicated when the lawyer handling the insured's defense is a staff attorney employed by the insurer. While some jurisdictions have banned insurers from using captive firms or staff attorneys to defend their insureds (*see* ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT at 51:324 for relevant authorities), "most authority finds no inherent conflict that would prevent lawyers from defending an insured merely because they are employed by an insurer as staff counsel." *Id.* The ABA/BNA Lawyers' Manual cautions, however, that these attorneys are subject to the same ethical duties of confidentiality, loyalty, and independent judgment owed to their insured clients as any other lawyers. *Id.* *See also* RESTATEMENT § 134, Reporter's Note at 413 (comparing judicial attitudes toward captive firms in various jurisdictions).

d. Model Rule 5.4: The Duty of Independent Judgment

Another key aspect of the attorney-client relationship concerns the lawyer's ability to exercise his or her professional judgment on behalf of the client. Rule 2.1 of the Model Rules of Professional Conduct emphasizes the lawyer's role as an advisor and requires the lawyer to exercise independent judgment and render candid advice to the client. The Model Rules make clear that this obligation should not be clouded by interference from a third party who recommends, employs, or pays that lawyer for undertaking the representation. *See* Rule 1.8(f) (prohibiting attorneys from accepting compensation from entities other than the client unless the client gives informed consent, the attorney can ensure that confidential client information remains protected, and there is no interference with the lawyer's professional judgment or with the attorney-client relationship); Rule 5.4(c) (prohibiting a lawyer from allowing a third party who recommends, employs, or pays that lawyer to direct or regulate the lawyer's professional judgment in providing legal services).

As a practical matter, many courts have held that policyholders relinquish control of their defense to their insurers when they execute policies containing a duty of cooperation clause and accept the representation offered by the insurer. *See* RESTATEMENT § 134, Reporter's Note, at 414 (citing cases). As discussed above, however, the insurer's direction and control cannot impede on defense counsel's ability to competently and effectively represent the insured, regardless of whether or not the insurer is considered a co-client. *See id.* at 413 ("The requirements of third-party payor rules such as ABA Model Rules of Professional Conduct. . . apply whether or not the insurer is also regarded as a client."). A key baseline inquiry for counsel defending an insured in the tripartite relationship is whether he or she can practice under the various dictates of the insurer, whatever they may be, without violating the duty of competent representation owed to the insured. Under Rule 1.1, "competent representation" requires the legal knowledge, skill, thoroughness, and preparation reasonably necessary to conduct the representation. Rule 1.1; *see also* RESTATEMENT § 52 (further explaining the attorney's duties of competence and diligence). The attorney must decline to follow a directive that hinders his or her ability to exercise independent professional judgment in the best interest of the client-insured. *See* Rule 1.7; ABA/BNA LAWYERS' MANUAL ON PROFESSIONAL CONDUCT, § 51:322.

This issue commonly arises with regard to the insurer's cost-containment measures briefly mentioned above, such as restrictions that limit the number of depositions an attorney can take or preclude the

attorney from performing legal research without prior approval. ABA Opinion 01-421 specifically addresses defense counsel's obligations when working under an insurer's litigation guidelines. Again the standard centers on the best interests of the insured – if the insurer's control of the litigation will result in a course of action that may be materially adverse to the insured, the attorney should consult with the insured and approach the insurer to see if there is any way to continue the representation under the insurer's directives. If the problem cannot be resolved sufficiently to protect the insured's material interests, however, then a conflict of interest results, and the attorney must withdraw pursuant to Rule 1.7.

3. UNDERSTANDING THE PARTIES' ROLES IN THE TRIPARTITE RELATIONSHIP

The players in the tripartite relationship can become somewhat of a dysfunctional family when the insurer agrees to defend the policyholder but does so under a reservation of rights. This becomes a problem when the potential exists for the defense lawyer to develop a case toward a result favorable to the insurer on the coverage issue, on the one hand, or to the policyholder on the other hand. For example, if an underlying complaint alleges mutually exclusive theories of recovery, such as negligence (covered) and intentional torts (not covered), both the carrier and the defense lawyer are put into difficult positions with potential ethical pitfalls. There are at least four main conflicts that may arise when there is a potential coverage dispute: (1) whether the insurer or the policyholder controls the defense; (2) whether the insurer or policyholder controls information; (3) the reasonableness of the attorney's fees and expenses and attempts by an insurer to manage litigation costs; and (4) whether the insurer or policyholder controls settlement. One of the best ways to deal with and avoid ethical dilemmas that may arise out of the tripartite relationship is to understand the roles and duties of all the players before engaging in the relationship. Accordingly, the insurer's selection of counsel should be exercised with a full awareness of the ramifications of the attorney-client relationship.

a. Right to Control the Defense

i. Policy Language Grants The Insurer The Exclusive Right to Control The Defense

Several provisions in a liability insurance policy express that the insurer, and not the policyholder, has the exclusive right to control the defense – the insuring agreement; the supplementary payments clause; the cooperation conditions; and the voluntary payments/obligations condition.⁸ For example, a standard CGL policy Insuring Agreement to Coverage A provides, in relevant part:

SECTION I – COVERAGES

COVERAGE A BODILY INJURY AND PROPERTY DAMAGE LIABILITY

1. Insuring Agreement

- a.** We will pay those sums that the insured becomes legally obligated to pay as damages because of "bodily injury" or "property damage" to which this insurance applies. We will have the right and duty to defend any "suit" seeking those damages. However, we will have no duty to defend the Insured against any "suit" seeking damages for "bodily injury" or "property damage" to which this insurance

⁸ Michael M. Marick and Karen M. Dixon, *The Insurance Contract "Right" to Defend: The "Tripartite" Relationship Reconsidered*, Tort Trial & Insurance Practice Law Journal, Summer 2004.

does not apply. We may, at our discretion, investigate any “occurrence” and settle any claim or “suit” that may result.

The Supplemental Payment provision provides, in relevant part:

SUPPLEMENTARY PAYMENTS –COVERAGE A AND B

1. We will pay, with respect to any claim we investigate or settle, or any “suit” against an insured we defend:

The Conditions provision provides, in relevant part:

SECTION IV – COMMERCIAL GENERAL LIABILITY CONDITIONS

2. Duties In The Event of Occurrence, Offense, Claim or Suit

c. You and any other involved insured must:

- (1) Immediately send us copies of any demands, notices, summons or legal papers received in connection with the claim or “suit”;
- (2) Authorize us to obtain records and other information;
- (3) Cooperate with us in the investigation or settlement of the claim or defense against the “suit”; and
- (4) Assist us, upon our request, in the enforcement of any right against any person or organization which may be liable to the insured because of injury or damage to which this insurance may also apply.

d. No insured will, except at the insured’s own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than for first aid, without our consent.

Liability insurance contracts generally provide that the insurer assuming the policyholder’s defense is entitled to control that defense. In fact, the insurer’s right to control the defense is an essential part of the business of insurance because the insurer needs to be able to manage its risks under the policy and predict its potential exposure.⁹ Moreover, when there are no coverage issues, the insurer, who will ultimately have to pay any judgment within the policy, has an economic incentive identical to that of the insured.¹⁰ Thus, the insured also benefits from the insurer’s control of the litigation because the end objectives are the same for both the insurer and the insured - to win the case. In cases where settlement or judgment is unavoidable, then both the insurer and the insured want to minimize the

⁹ Tanya Bryant, *Loyalty Divided? Ethical Considerations of the Tripartite Relationship in Insurance Defense Litigation*, Oklahoma City Law Rev., Fall 2004.

¹⁰ *Id.*

financial impact. The disadvantages to this arrangement surface, however, when the insurer tries to restrict the lawyer's defense of the insured based upon cost control or other considerations, such as when the insurer and insured are not in agreement regarding a settlement.¹¹ Things get even more interesting when the insurer is providing a defense under a reservation of rights to disclaim its coverage obligation. In that instance, the insurer's motivation to establish that the claim does not fall within the policy's coverage may be perceived as overriding or interfering with its incentive to minimize the policyholder's liability.¹²

ii. The Right To Select Defense Counsel: A Multi-State Survey

(1) Alabama

Under Alabama law, a carrier defending under a reservation of rights does not necessarily give the policyholder the right to select independent defense counsel at the insurer's expense. *See L&S Roofing Supply Co. v. St. Paul Fire & Marine Ins. Co.*, 521 So.2d 1298 (Ala. 1987) (carrier's defense under reservation of rights does not create a conflict of interest such that policyholder is entitled to engage defense counsel; carrier not obligated to pay for policyholder's independent counsel under reservation of rights); *See also Strength v. Alabama Dept. of Finance Div. of Risk Mgmt.*, 622 So.2d 1283, 1290 (Ala. 1993) (rejecting absolute approach in which any reservation of rights entitles policyholder to select own counsel).

(2) California

California has codified the decision reached in the well known *Cumis* decision. Under California Civil Code §2860 (1996) a conflict of interest creates a duty for the carrier to provide independent counsel, unless the policyholder waives the right in writing. The policyholder's choice of counsel, however, is limited by the insurer's customary rates and minimum qualifications. *See San Diego Navy Federal Credit Union v. Cumis Ins. Society*, 162 Cal.App. 3d 358, 208 Cal.Rptr. 494 (1984). Moreover, the conflict of interest must be an *actual* conflict. A mere potential or theoretical conflict is not sufficient. *Id.*; *See also Center Foundation v. Chicago, Ins. Co.*, 227 Cal.App. 3d 547, 278 Cal. Rptr. 13 (Cal.App. Dist. 2 1991) (carrier may approve selection of counsel by policyholder). *Dynamic Concepts, Inc. v. Truck Ins. Exchange*, 61 Cal.App. 4th 999, 1007, 71 Cal.Rptr. 882 (Cal.App. 4 Dist. 1998) (a mere possibility of an unspecified conflict does not require independent counsel; conflict must be significant (not merely theoretical) and actual (not merely potential)); *Clarendon Nat'l Ins. Co. v. Insurance Co. of the West*, 442 F.Supp. 2d 914 (E.D. Cal. 2006) (mere reservation of rights does not create conflict of interest requiring independent counsel; conflict must be actual and significant, not potential or theoretical). *Monarch Plumbing Co., Inc. v. Ranger Ins. Co.*, 2006 WL 2734391 (E.D. Cal. Sept. 25, 2006) (insurer has right to control defense so long as there is no conflict of interest; not every conflict entitles insured to independent counsel). For example, mere allegations of punitive damages are not sufficient conflict to conflict *Cumis* counsel. *Foremost Ins. Co. v. Wilks*, 206 Cal.App. 3d 251, 253 Cal.Rptr. 596 (Cal.App. 3 Dist. 1988). However, even where the policyholder is entitled to select its own counsel, the carrier is not necessarily precluded from separately negotiating settlement. *Western Polymer Technology, Inc. v. Reliance Ins. Co.*, 32 Cal.App. 4th 14, 38 Cal.Rptr. 2d 78 (Cal.App. 1 Dist. 1995).

¹¹ Tanya Bryant, *Loyalty Divided? Ethical Considerations of the Tripartite Relationship in Insurance Defense Litigation*, Oklahoma City Law Rev., Fall 2004.

¹² *Id.*

Despite the codification of the *Cumis* opinion, the Ninth Circuit has yielded some inconstant opinions on this issue. See e.g. *Gafcon v. Ponsor & Assoc.*, 98 Cal.App. 4th 1388, 120 Cal.Rptr. 2d 392 (Cal.App. 4 Dist. 2002) (where insurance carrier opposes need for *Cumis* counsel, it must show that select defense counsel could not impact coverage outcome); *Cybernet Ventures, Inc. v. Hartford Ins. Co. of the Midwest*, 168 Fed.Appx. 850 (9th Cir. 2002) (unpublished) (reservation of rights relates only to amount of damages and not to question of liability, no conflict requiring independent counsel); *Allstate Ins. Co. v. Breshearts*, 154 Fed.Appx. 671 (9th Cir. 2005) (unpublished) (where no conflict, no requirement to provide independent counsel).

(3) Florida

Although Florida, like California, allows the policyholder to retain independent counsel under certain circumstances, Florida law puts a great deal more onus on the policyholder to establish why the insurer's counsel of choice is unacceptable. Recently, a federal district court concluded that the policyholder must show actual prejudice, harm, or some equally compelling reason why the insurer's appointed counsel was not agreeable. *Prime Ins. Syndicate, Inc. v. Soil Tech Distributors*, 2006 WL 1823562 (M.D. Fla. June 30, 2006). Moreover, the policyholder must affirmatively reject the carrier's defense offered under a reservation of rights before she can retain her own lawyer. *Aguero v. First American Ins. Co.*, 927 So.2d 894 (Fla.App. 3 Dist. 2005); See also *Continental Ins. Co. v. Miami Beach*, 521 So.2d 232 (Fla.App. 3 Dist. 1998) (policyholder's approval as to selection of independent counsel appointed by carrier is required; policyholder must mutually agree to the appointment of independent counsel).

(4) Illinois

The cases applying Illinois law generally tend to favor the policyholder, although there are a few decisions holding to the principle that there must be a true conflict, not just possible or alleged conflicts of interest. See e.g. *Shelter Mut. Ins. v. Baily*, 513 N.E.2d 490 (Ill.App. 5th Dist. 1987); *Tews Funeral Home, Inc. v. Ohio Cas. Ins. Co.*, 832 F.2d 1037, 1047 (7th Cir. 1987) (applying Illinois law) (carrier entitled to control defense with attorneys it chose because interest in negotiating policy coverage is not enough for conflict). If there is a true conflict of interest, the carrier must decline to defend and pay for independent counsel. *Murphy v. Urso*, 88 Ill.2d 444, 454, 430 N.E.2d 1079, 1084 (1981) (carrier must decline to defend where conflict of interest and must pay for independent counsel; "the insured has the right to be defended by counsel of his own choosing"); *American Family Mut'l Ins. Co. v. W.H. McNaughton Builders, Inc.*, 363 Ill.App. 3d 505, 843 N.E.2d 492 (Ill.App. 2 Dist. 2006) (where conflict of interest exists, policyholder is entitled to be defended by attorney of his own choosing). See also *Williams v. American Country Ins. Co.*, 359 Ill.App. 3d 128, 833 N.E.2d 971 (Ill.App. 1 Dist. 2005) (where conflict between carrier and policyholder, carrier must pay costs of independent counsel); *Restoration Specialists, LLC v. First Specialty Ins. Corp.*, 403 F.Supp.2d 650 (N.D. Ill. 2005), vacated in part by *Restoration Specialists, LLC v. First Specialty Ins. Corp.*, 2006 WL 3347899 (N.D. Ill. October 6, 2006) (policyholder may appoint counsel to control litigation if its interests conflict with carrier; carrier must decline to participate in defense of policyholder).

(5) Louisiana

Louisiana courts have not adopted a consistent approach to determining whether an insured can retain its own counsel at the insured's expense, and the outcome of each case are somewhat fact specific. See e.g. *Shehee-Ford Wagon & Harness v. Continental Cas. Co.*, 170 So. 249 (La.App. 2d Cir. 1936)

(where liability carriers denies validity of policy, policyholder is warranted in hiring own counsel and carrier liable for expense of same); *Trinity Universal Ins. Co. v. Stevens Forestry Service, Inc.*, 335 F.3d 353 (5th Cir. 2003) (where carrier provides competent counsel, it is not required to cover attorneys fees of counsel hired by policyholder, regardless of reservation of rights, complexity of case, and whether independent counsel was beneficial to defense); *Dugas Pest Control of Baton Rouge v. Mut'l Fire, Marine & Inland Ins. Co.*, 504 So.2d 1051 (La.App. 1st Cir. 1987) (if carrier chooses to defend policyholder but deny coverage, it must hire separate counsel).

(6) New York

Under New York law, the insured is entitled to independent counsel at the carrier's expense if there is a clear conflict of interest. *New York State Urban Development Corp. v. VSL Corp.*, 563 F.Supp. 187 (S.D.N.Y. 1983) (where conflict of interest, carrier's choice of independent counsel upheld); *U.S. Underwriters Ins. Co. v. TNP Trucking, Inc.*, 44 F.Supp. 2d 489 (E.D.N.Y. 1999) (absent clear conflict of interest, policyholder not permitted to replace carrier's chosen counsel with its own independent choice); *Public Service Mut'l Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 425 N.E.2d 810, 442 N.Y.S 2d 422 (1981) (given actual conflict, policyholder entitled to attorney of his own choosing, whose reasoning fee is to be paid by carrier); *69th Street and 2nd Avenue Garage Assos. L.P. v. Tigor Title Guar. Co.*, 207 A.2d 225, 228, 622 N.Y.2d 13 (N.Y. App. Div. 1 1995) (crucial conflict of interest gave policyholder right to own attorneys); *Rimar v. Continental Cas. Co.*, 50 A.D.2d 169 (N.Y.App. 1975) (where conflict of interest, policyholder allowed to choose own counsel to be paid by carrier; control of defense must yield to obligation to defend).

Recently, a federal district court has held that the policyholder is entitled to select counsel at carrier's expense only when conflict arises *that places loyalty of counsel to the policyholder in doubt*. *Avallone, Avelles, & Kaufman, LLP*, 2006 WL 2135782 at *15 (E.D.N.Y. July 28, 2006) (finding no right to independent counsel because there was no actual or potential conflict); *See also Cunnif v. West field, Inc.*, 829 F.Supp. 55 (E.D.N.Y. 1993) (where conflict of interest arises such that question of loyalty to policyholder by its counsel policyholder is entitled to select its counsel).

If the policyholder is able to chose independent counsel, that counsel's fees must be reasonable; *Allstate Ins. Co. v. Noorhassan*, 158 A.D.2d 638 (N.Y. App. 1990) (policyholder is allowed to select own attorney with carrier to pay reasonable fees); *Emons Industries, Inc. v. Liberty Mut'l Ins. Co.*, 749 F.Supp. 1289, 1297 (S.D.N.Y. 1990) (where conflict of interest, policyholder entitled to select its counsel, whose reasonable fee is to be paid by carrier); *Prashker v. U.S. Guarantee Co.*, 136 N.E.2d 871 (1956) (where conflict of interest, policyholder selects counsel, carrier remains liable for payment of reasonable value of services of attorney selected by policyholder); *Cunnif*, 829 F.Supp. at 55 (same).

At least one New York Court has determined that the carrier does not have an affirmative duty to inform the policyholder of its right to selection of counsel. *Sumo Container Station, Inc. v. Evants, Orr, Pacelli, Norton and Laffan, P.C.*, 278 A.D.2d 169 (N.Y.App. 2000) (no affirmative duty to inform policyholder of its right to selection of counsel.); *See also First Jeffersonian Assoc. v. Ins. Co. of N. America*, 262 A.D.2d 133 (N.Y.App. 1999) (under reservation of rights, policyholder entitled to counsel of own choosing and to reimbursement of reasonable costs; however, policyholder not entitled to recover legal expenses in action to recover those costs).

(7) Texas

In many discussions about the tripartite relationship, Texas is improperly lumped in with other states, like Alabama, Kentucky, and Florida that have determined that a policyholder is entitled to representation by independent counsel whenever the insurer issues a reservation of rights. Policyholder counsel frequently and incorrectly assert that under Texas law, an insured may choose its own counsel at the insurer's expense any time the insurer agrees to defend subject to a reservation of rights. *See e.g. Rx.com, Inc. v. Hartford Fire Ins. Co.*, 426 F.Supp. 546, 559 (S.D.Tex.2006). Texas law is actually narrower. An insurer's "right to defend" a lawsuit "encompasses the authority to select the attorney who will defend that claim and to make other decisions that would normally be vested in the insured as the named party in the case." *Id.*; *N. County Mut'l Ins. Co. v. Davalos*, 140 S.W.3d 685, 688 (Tex.2004). Not every reservation of rights creates a conflict of interest allowing an insured to select independent counsel. Rather, the existence of a conflict depends on the nature of the coverage issues as they relate to the underlying case. *Id.* If the insurance policy, like the policy at issue in the *Rx. Com* case, gives the insurer the right to control the defense of a case, the insured cannot choose independent counsel and require the insurer to reimburse the expenses unless "the facts to be adjudicated in the liability lawsuit are the same facts upon which coverage depends." *Davalos*, 140 S.W.3d at 689. If the issue on which coverage turns is independent of the issues in the underlying case, counsel selected by the insured is not required. A true conflict of interest does not arise unless the outcome of the coverage issue can be controlled by counsel retained by the insurer for the defense of the underlying claim. *Davalos*, 140 S.W.3d at 689. This rule allows insurers to control costs while permitting insureds to protect themselves from an insurer-hired attorney who may be tempted to develop facts or legal strategy that could ultimately support the insurer's position that the underlying lawsuit fits within a policy exclusion. *Rx.com*, 426 F.Supp. at 560.

For example, in *Rx.com*, the petition in the underlying claim asserted the following claims: breach of fiduciary duty; shareholder oppression; conspiracy; actual and/or constructive fraud; fraudulent inducement; conversion; intentional infliction of emotional distress; breach of contract; and negligent misrepresentation. *Id.* at 560. The underlying petition also included allegations that the defendants knowingly made false and misleading statements about one of the plaintiffs. The underlying plaintiffs also alleged the defendants intentionally made derogatory false statements to third parties about the plaintiffs in order to further their purposes and business. The Hartford reserved its rights on the basis that the certain facts in the amended petition did not allege an "occurrence" as that term was defined in the Hartford policy. *Id.* The reservation of rights letter did not reserve its rights on any exclusions in the policy; rather, it reserved on the basis of the limiting language in the insuring agreement. Hartford also included a blanket reservation of rights under the policy.

After receiving the reservation of rights letter, *Rx.com* hired independent defense counsel and filed a declaratory judgment action seeking reimbursement from Hartford's for defense counsel's fees and expenses. The court held that *Rx.com* failed to show, as a matter of law, the facts to be decided in the underlying lawsuit were the same facts that would defeat coverage by triggering a policy exclusion. The court observed that the Hartford reservation of rights letter did not invoke a coverage exclusion that would be established by proof of the same facts to be decided in the underlying lawsuit. Therefore, the court held that Hartford's refusal to pay *Rx.com*'s independent counsel was not a breach of contract. *Id.* at 562.

There are certain fact scenarios which present a serious conflict between the interests of the insured and the insurer and, depending upon how the case is resolved, will dictate whether the insured will be entitled to any indemnity coverage. *See e.g. Houston Auth. of the City of Dallas, Tex. v. Northland, Ins.*

Co., 333 F.Supp.2d 595, 601 (N.D.Tex.2004) (because the liability facts and coverage facts were the same and because a potential conflict of interest was created by the issuance of the reservation of rights letter, a disqualifying conflict existed); Cf. *Davalos*, 140 S.W.3d at 685 (disagreement over the venue is not a sufficient reason to take the contractual right to conduct the defense away from the insurer). This type of conflict of interest was found in *Maryland Casualty v. Peppers*, 355 N.E.2d 24 (Ill.1976). In that case, Mims sued the insured, Peppers, in a personal injury action. The insurance carrier, St. Paul, issued a policy that did not cover intentional harm. The complaint contained allegations of both intentional and unintentional harm. The court recognized that the attorney who was retained by St. Paul as defense counsel faced a conflict. It was in St. Paul's interest for Peppers' actions to be found intentional so that they would have no indemnity obligation under the insurance policy. Peppers, on the other hand, hoped to be found negligent in order to be covered under the policy. The court stated that due to the conflict, Peppers had the right to be defended in the personal injury case by an attorney of his own choice who should have the right to control the conduct of the case. *Id.*

(8) Washington

Washington courts have rejected the contention that a conflict of interest automatically exists when an insurer agrees to defend an insured under a reservation of rights. *Johnson v. Continental Cas. Co.*, 788 P.2d 598 (Wash. 1990) (no requirement for carrier to pay for policyholder's personal attorney absent clear of interest). Further, even where there is a conflict of interest, Washington law may still allow the carrier to select defense counsel, but the carrier will be charged with an "enhanced duty of good faith" in those limited situations. *Tank v. State Farm Fire & Cas. Co.*, 715 P.2d 1133 (Wash. 1986).

b. Withdrawing a Defense

When a defense is undertaken through a valid reservation of rights, the insurer may withdraw its defense when it becomes clear there is no coverage under the policy. *Hagen v. Aetna Cas. and Sur. Co.*, 675 So.2d 963, 968 (Fla. Ct. App. 1996); See *Katerndahl v. State Farm Fire & Cas. Co.*, 961 S.W.2d 518, 512 (Tex.App.-San Antonio 1997). But proper notice is required to be given by the insurer when it discovers a valid policy defense and intends to withdraw. See *W. Cas. & Sur. Co. v. Newell Mfg. Co.*, 566 S.W.2d 74 (Tex.App.-San Antonio 1978); *Hartford Ins. Group v. Mello*, 81 A.D.2d 577 (N.Y. App. Div. 1981). Thus, where an insurer discovers a valid defense to coverage, but fails to properly communicate a reservation of rights or otherwise notify the insured of the coverage defense, it will lose its right to later litigate coverage. *United Service Auto Ass'n v. Morris*, 741 P.2d 246, 249 (Ariz. 1987). In New York, for example, courts have used the doctrine of estoppel to bar an insurer from withdrawing its defense where the insurer fails to notify its insured of a discovered defense to coverage. *Hartford Ins. Group v. Mello*, 81 A.D.2d 577 (N.Y. App. Div. 1981). The reason for this application was succinctly explained by the New York Court of Appeals: "where an insurer, though in fact not obligated to provide coverage, without asserting policy defenses or reserving the privilege to do so, undertakes the defense of the case, in reliance on which the insured suffers the detriment of losing the right to control its own defense. . . . though coverage as such does not exist, the insurer will not be heard to say so." *Schiff v. Flack*, 51 N.Y.2d 692, 699 (N.Y. 1980). Cf. *Pennsylvania Nat'l Mut. Cas. Ins. Co. v. Kitty Hawk Airways, Inc.*, 964 F.2d 478, 480-81 (5th Cir.1992) (indicating that while under Texas law estoppel generally may not be used to create coverage under the policy, there are well-recognized exceptions). Of course, estoppel cannot be used to create coverage where there is no insurance contract to begin with. *Wausau Ins. Co. v. Feldman*, 623 N.Y.S.2d 242, 244 (N.Y. App. Div. 1995).

From a practical standpoint, an insurer withdrawing a defense should provide its insured with a detailed explanation of the insurer's coverage position. Moreover, the insurer should allow the insured sufficient time to respond and/or provide the insurer with evidence the insured may have that it would like considered in the carrier's coverage analysis. Further, carriers should be mindful of the timing of the withdrawal and avoid being perceived as acting in bad faith. Because the question of whether a defense to coverage exists can be fact intensive, the issue of information control can give rise to ethical dilemmas.

c. Control of Information

Difficulties can arise between the insurer, the policyholder, and defense counsel with respect to information generated and accumulated as the litigation unfolds. While communications between the policy holder and the insurer are generally protected from disclosure to third parties by the work product doctrine,¹³ questions may arise concerning the duty of the policyholder and defense counsel to share information with the insurer discovered in the underlying action. This is especially true with information that could give rise to a coverage defense. As one court has stated:

[D]efense counsel and the insurer inevitably share information about claims. With defense counsel and the insurer in frequent contact over the details of the litigation, the insurer has ample opportunity to inform defense counsel how different approaches to the claim might affect its interests. When the interests of the insurer differ from those of the insured, defense counsel who represents both may find itself in what we have called "an exceedingly awkward position."

Pine Island Farmer's Coop v. Erstad & Reimer, PA, 639 N.W.2d 444, 450 (Minn. 2002). Of course, the resolution of these questions hinges in large part on whether the defense counsel has only one client – the insured party – or whether he has other obligations, as discussed above.

Generally speaking, defense counsel has a duty to disclose to the insurer all information concerning the action relevant to the underlying lawsuit, and to timely inform and consult with the insurer on all matters relating to the action. Potential problems arise where defense counsel obtains confidential information from the insured that happens to support the insurer's basis for reserving its rights. This could occur where the defense counsel needs the information from the insured in order to provide the best defense possible, or where defense counsel simply discovers the information. In the event that coverage litigation ensues the insurer may attempt to obtain this information from defense counsel. Defense counsel must be sure not to reveal confidential or privileged information to either the insurer or the insured without informed consent, and must be aware of the ethical rules regarding confidentiality, as well as the relevant state law regarding the nature of the attorney-client relationship.

The defense attorney's failure to abide by these rules can lead to dire consequences for the insurer and possible ethical sanctions for the defense attorney. For example, in *Parsons v. Continental National American Group*, 550 P.2d 94 (Ariz. 1976), the insurer undertook the defense of a minor who attacked several other individuals because the minor apparently did not have control of himself during these attacks and thus his actions were covered under the policy. During discovery, the hired defense

¹³ For example, Federal Rule of Civil Procedure 26(B)(3) and some state rules such as Texas Civil Procedure Rule 192.5 specifically include insurers under their work product protection. Thus, status reports and other information prepared for the carrier by defense counsel are generally privileged.

counsel discovered a confidential file from the minor's school (a maximum security psychiatric institution) indicating that the boy was fully aware of his actions and that he knew his actions were wrong. Defense counsel shared this information with the insurer, which promptly issued a reservation of rights letter. *Id.* at 96. On appeal to the Arizona Supreme Court, the minor contended that the insurer should be estopped from denying coverage because the insurer had "[taken] advantage of the fiduciary relationship between its agent (the attorney) and [the insured]." *Id.* at 97. The Supreme Court agreed, holding that the attorney had breached his fiduciary duty to the insured by divulging the confidential information and should have notified the insurer that he could not represent them after obtaining this information. The Court went on to hold that this conduct constituted a waiver of any denial of coverage based on the confidential information because the "conflict of interest constitutes a source of prejudice upon which the insured may invoke the doctrine of estoppel." *Id.* at 99. *See also Woodstream Corp. v. Pennsylvania Manufacturer's Ass'n Ins. Co.*, 21 Pa. D. & C.3d 627 (Pa. Com. Pl. 1982) (warning of similar dangers).

d. Reasonableness of Defense Costs

i. The Duty To Defend Includes Reimbursing Counsel For Its Reasonable Fees.

The duty of good faith imposed on the insurer includes the obligation to act reasonably in selecting as defense counsel an experienced attorney qualified to present a meaningful defense and willing to engage in ethical billing practices susceptible to review at a standard stricter than that of the marketplace.¹⁴ Moreover, it is generally accepted that the insurer can require the defense counsel to follow written billing guidelines.

But where an insurer fails to provide a meaningful defense or undertake a defense altogether (breaching its duty to defend), courts have allowed the policy holder to recover as damages attorney fees incurred in adequately defending the underlying litigation. *See, e.g., Underwriters at Lloyds v. Denali Seafoods, Inc.*, 927 F.2d 459, 464 (9th Cir.1991); *Bainbridge Inc. v. Travelers Casualty Co. of Connecticut*, 159 P.3d 748, 756 (Colo.App.2006); *Continental Cas. Co. v. City of South Daytona*, 807 So.2d 91, 93 (Fla. Ct. App. 2002); *Rx.com, Inc. v. Hartford Fire Ins. Co.*, 426 F.Supp.2d 546, 559 (S.D.Tex.2006); *Am. Home Assur. Co. v. United Space Alliance*, 378 F.2d 482 (5th Cir. 2004). For example, where the insured is dissatisfied with the hired defense-counsel's lack of preparation for trial, and uses its own attorneys to ensure an adequate defense, it may be able to recover its own counsel's attorney fees. *Carousel Concessions, Inc. v. Fla. Ins. Guar. Ass'n*, 483 So.2d 513, 516 (Fla. Ct. App. 1986). Although the insurer generally must reimburse the insured only for attorney fees as stated in the contract or mandated by statute, some courts have extended this obligation to defense costs incurred in a declaratory judgment action by or against the insurer regarding coverage.¹⁵

The insurer's defense obligation extends to reimbursing counsel for "reasonable" fees and expenses incurred in conducting the defense. The existing body of case law on what constitutes "reasonable" attorneys' fees is sparse. The initial burden in proving the reasonableness of attorney fees is generally placed upon the insured. *Emhart Industries, Inc. v. Home Ins. Co.*, 515 F.Supp.2d 228, 251 (D.R.I. 2007) (citing 14 Couch on Insurance § 205:76). Courts addressing the issue of "reasonableness" tend

¹⁴Dale Hausman, *Conflict Issues in the Tripartite Relationship*, Practising Law Institute and Administrative Practice Course Handbook Series, Litigation, Insurance Law 2006.

¹⁵ There is a fragmented split of authority on this issue too detailed to discuss here. The issue is comprehensively addressed in Ostrager and Newman, *Handbook on Insurance Coverage Disputes* § 5.05[b] (Eighth Ed. 1995).

to apply a factor-based approach, where the factors applied in determining reasonableness include “the amount in issue, the questions of law involved and whether they are unique or novel, the hours worked and the diligence displayed, the result obtained, and the experience, standing and ability of the attorney who rendered the services.” *Id.* (quoting *Palumbo v. U.S. Rubber Co.*, 102 R.I. 220, 229 A.2d 620, 622-23 (1967)). *See also Fireman's Fund Ins. Co. of Wis. v. Bradley Corp.*, 660 N.W.2d 666, ¶ 67 (Wis. 2003) (listing many of the same factors to determine the “reasonableness” of attorney fees). It would be prudent for all parties, but especially hired defense counsel, to refer to the ethical rules governing the reasonableness of attorney fees. The ABA Model Rules, Rule 1.5, lists a number of factors to be considered in determining the reasonableness of attorney fees. Included are the time and labor required, the novelty and difficulty of the questions involved, the skill needed, the fee customarily charged in the locality, the amount at stake, time limitations imposed by the client, and the experience, reputation, and ability of the lawyer, among other factors. *Center Foundation v. Chicago Ins. Co.*, 278 Cal.Rptr.13 (Cal.App.1991) offers some additional guidance. The *Center Foundation* court suggests that defense counsel may be subjected to stricter-than-normal standards in its billing practices and should be prepared for heightened scrutiny regarding its conduct of the defense. *Id.*

ii. Billing Guidelines

Billing guidelines are commonplace for insurance companies that routinely hire defense counsel to represent their insureds. Generally speaking, these guidelines serve two main purposes. First, billing guidelines are utilized by insurers as an attempt to control costs, ensure that the lawyer’s fees are “reasonable and necessary,” and also to provide a consistent guideline for defense lawyers. Second, insurers also use billing guidelines to eliminate confusion that may later arise regarding a particular matter. Defense counsel should be familiar with and willing to live by the carrier’s billing guidelines before engaging in a contractual relationship with the carrier.¹⁶

Conflicts over billing requirements can be alleviated when carriers and defense counsel communicate and work together to efficiently prepare and present the best possible defense for the insured. Insurance carriers should be mindful that a defense lawyer may be in a difficult situation if he or she is prohibited or restricted from performing tasks that would benefit the defense of the insured. At the time the lawyer agrees to the carrier’s billing guidelines, she is likely unaware of exactly what a specific case may entail. Each case is different and may require more or less of the tasks necessary to defend the insured. Additionally, defense lawyers should be aware that insurers are generally willing to cooperate with lawyers with whom they have had a long standing relationship, and revising the “litigation budget” is an ongoing processes. A lawyer should not just “eat” the loss without first consulting with the insurer. The lawyer should document every task performed whether covered or not.¹⁷

e. Control of Settlement: A Multi-State Survey

i. General Overview of the Duty to Settle

¹⁶Tanya S. Bryant, *Loyalty Divided? The Ethical Considerations of the Tripartite Relationship in the Insurance Defense Litigation*, Oklahoma City University Law Rev., Fall 2004.

¹⁷Tanya S. Bryant, *Loyalty Divided? The Ethical Considerations of the Tripartite Relationship in the Insurance Defense Litigation*, Oklahoma City University Law Rev., Fall 2004.

Liability insurance contracts generally provide that the insurer may assume the control over the settlement of any litigation against its insured.¹⁸ When a settlement offer is made which may favor one party's interest over the other party's interest, difficult questions arise relating to the varying, and often conflicting, interests of the insurer on the one hand, and those of the policyholder and defense counsel on the other.¹⁹ The policy holder will normally want to settle if the settlement offer is within policy limits, in order to avoid the possibility of an excess judgment at trial. But the insurer, knowing that the maximum it would have to pay out is the policy limit, may very well want to refuse a settlement offer where there is a possibility of winning at trial and paying nothing at all.

In order to resolve this conflict of interest, many courts have required the insurer to reasonably pursue settlement opportunities. The contours of this obligation differ from jurisdiction to jurisdiction. Some states impose a duty on insurers to consider the policyholder's interest at least equally with its own when considering a potential settlement. *See e.g. Merritt v. Reserve Ins. Co.*, 110 Cal.Rptr. 511 (Ct.App.1974); *Fulton v. Woodward*, 545 P.2d 979 (Ariz.Ct.App. 1976); *Hartford Accid. & Indem. v. Foster*, 528 So.2d 255 (Miss. 1988). Moreover, the insurer may be held liable for damages in excess of policy limits if it fails to accept a settlement within policy limits without making a diligent assessment of the issue.²⁰ Other jurisdictions, such as New York, only impose liability on the insurer for refusing to settle where the insurer acts with "gross disregard" of the insured's interests. *See Pavia v. State Farm Mutual Automobile Ins. Co.*, 626 N.E.2d 24, 27 (N.Y. 1993). And some jurisdictions seem not to recognize a distinct "duty" to settle, but rather analyze the problem under the duty to act in "good faith" generally. *See, e.g., Smith v. Audubon Ins. Co.* 679 So.2d 372, 376-77 (La. 1996) ("In the absence of bad faith, a liability insurer generally is free to settle or to litigate at its own discretion, without liability to its insured for a judgment in excess of the policy limits."); *Hoskins v. Aetna Life Ins. Co.*, 452 N.E.2d 1315, 1319 (Ohio 1983).

Rule 1.2 of the Model Rules of Professional Conduct states that "[a] lawyer shall abide by a client's decision whether to accept an offer of settlement of a matter." In most liability claims, the insurer has the right to settle a matter without the consent of the insured. The insured usually does not have a say in the matter except in the limited circumstances involving professional liability insurance. Even though the insurer is generally not under a legal duty to obtain insured's consent before settlement, the attorney's role is problematic especially in cases where (a) the attorney represents both the insured and the insurer and (b) the insurer and the insured are not in agreement on whether or not to settle the matter.²¹

Although liability insurance contracts generally provide that the insurer may assume control over the settlement of any litigation against its insured, there are certain situations that may arise that create questions as to whether the insurer or the policyholder should assume control over the settlement negotiations or decisions when a true coverage conflict exists.²² For example, if a policyholder has

¹⁸ Some liability policies provide a "consent clause," which requires the carrier to obtain the policyholder's consent before settling a claim. If an insured refuses to consent to a settlement amount posed by the carrier and the case settles for a higher amount, most "consent clauses" provide the insurer with the opportunity to recoup the difference in the settlement amounts from the insured.

¹⁹ Dale E. Hausman, *Conflict Issues in the Tripartite Relationship*, Practising Law Institute Litigation and Administrative Practice Course Handbook Series Litigation, Insurance Law 2006: Understanding the ABC's, April 2006.

²⁰ *Id.*

²¹ Shawn McParland Baldwin, *One Step Beyond Meadowbrook: Can an Insurer Direct Defense Counsel to Dismiss Covered Claims? An Examination of Insurance Defense Attorney's Roles and Ethical Duties*, Defense Counsel Journal April, 2005.

²² Dale E. Hausman, *Conflict Issues in the Tripartite Relationship*, Practising Law Institute Litigation and Administrative Practice Course Handbook Series Litigation, Insurance Law 2006: Understanding the ABC's, April 2006.

assumed control of its own defense because of a true coverage conflict with the insurer, it can be argued that the policyholder should also be vested with the authority over settlement decisions as well. On the other hand, it has been argued that because the duty to defend is distinct from the duty to indemnify, the policyholder should not be afforded the same control over settlement as it has over the defense.²³ Given the variety of approaches taken by the various states on the duty to settle, a state survey is necessary.

ii. Texas

Texas law is very instructive on the insurer's role in settlement negotiations. Under the *Stowers* doctrine, the insurer must act with "that degree of care and diligence which an ordinarily prudent person would exercise in the management of his own business" in responding to settlement demands within policy limits. *Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d 544, 547-48 (Tex. Comm'n App. 1929, holding approved). According to *Stowers*, the insurer is exposed to this additional risk because that insurer was presented with a reasonable opportunity to settle within policy limits, but failed to do so. *American Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, 849 (Tex. 1994).

The imposition of the *Stowers* duty is intended to protect the policyholder from an insurer abusing the control of defense and settlement. The threat of having to pay an excess judgment seeks to prevent an insurer from gambling at the policyholder's risk and expense by failing to settle a claim that can and should be settled within the policy limits, thereby leaving the policyholder responsible for an uninsured loss beyond those primary limits.

The *Stowers* duty is triggered by a claimant's settlement demand when the following three prerequisites are met: (1) the claim against the insured is within the scope of coverage; (2) the demand is within the policy limits, and (3) the terms of the demand are such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment. Under *Stowers*, an insurer is not required to affirmatively initiate any settlement offer nor is it required to engage in any give-and-take settlement negotiations. The *Stowers* duty arises solely in relation to the actual settlement demand proposed by the claimant. *Id.*; *Garcia*, 876 S.W.2d at 49-51; *Birmingham Fire Ins. v. American Nat'l Fire*, 947 S.W.2d 598, 597-99 (Tex.App.-Houston [1st Dist.] 1995).²⁴

A *Stowers* demand is not required to be in writing, although a demand in writing is clearly preferable in order to ensure there is no question of its terms. Regardless of whether it is memorialized, the demand should be clear and undisputed. *Rocor Int'l, Inc. v. Nat. Union Fire Ins. Co. of Pittsburg, Pa.*, 77 S.W.3d, 253, 263 (Tex.2002). The demand must specifically offer a settlement within the policy limits, although this can be accomplished by substituting "policy limits" for a sum certain. *Garcia*, 876 S.W.2d at 848. The demand must release all claims, including applicable liens, and the demand must be unconditional. *Ins. Corp. of America v. Webster*, 906 S.W.2d 77 (Tex.App.--Houston [1st Dist.]

²³ *Id.*

²⁴ The Texas Supreme court has once said that an insurer owes its insured a duty of ordinary care that includes "investigation, preparation for defense of the lawsuit, trial of the case, and reasonable attempts to settle." *Ranger County Mut'l Ins. v. Guin*, 723 S.W.2d 656, 659 (Tex.1987), the *Garcia* court declared that the statement was to be taken in the limited context of examining the insurer's fulfillment of its *Stowers* duty. See also Russell H. McMains, *Updating the Stowers Minefield*, University of Houston Law Foundation Advanced Insurance and Tort Claims, June 2006.

1995, writ denied)(no valid *Stowers* demand where settlement was conditioned on a plaintiff's understanding that there was not additional insurance available).²⁵

The third prong of the *Stowers* test, the reasonable demand requirement, has not been clearly interpreted by the courts. Certainly, a third party liability insurer must exercise "that degree of care and diligence in the management of his own business" in responding to settlement demands within policy limits. *Stowers*, 15 S.W.2d at 547. The terms of the demand must be such that an ordinarily prudent insurer would accept it, considering the likelihood and degree of the insured's potential exposure to an excess judgment. *Id.* at 849.²⁶

iii. Florida

Florida law is similar to that of Texas, but imposes some additional concrete and specific obligations upon the insurer regarding the handling of settlement. Generally, an insurer owes a duty of good faith to its insured. *Berges v. Infinity Ins. Co.*, 896 So.2d 665, 672 (Fla. 2004). This duty of good faith includes the obligations to advise the insured of settlement opportunities, advise the insured of any steps that may be taken to avoid an excess judgment, and to generally protect the insured from a judgment above the insured's policy limits. *Id.* As explained by the Florida Supreme Court in *Boston Old Colony Insurance Co. v. Gutierrez*, 386 So.2d 783, 785 (Fla. 1980):

An insurer, in handling the defense of claims against its insured, has a duty to use the same degree of care and diligence as a person of ordinary care and prudence should exercise in the management of his own business. For when the insured has surrendered to the insurer all control over the handling of the claim, including all decisions with regard to litigation and settlement, then the insurer must assume a duty to exercise such control and make such decisions in good faith and with due regard for the interests of the insured. This good faith duty obligates the insurer to advise the insured of settlement opportunities, to advise as to the probable outcome of the litigation, to warn of the possibility of an excess judgment, and to advise the insured of any steps he might take to avoid same. The insurer must investigate the facts, give fair consideration to a settlement offer that is not unreasonable under the facts, and settle, if possible, where a reasonably prudent person, faced with the prospect of paying the total recovery, would do so.

Based upon these duties, an insurer may be subject to a claim of bad faith where it fails to consider a reasonable settlement offer, and the insured is subsequently exposed to an excess judgment. *Rosen v. Fla. Ins. Guar. Ass'n*, 802 So.2d 291, 294 (Fla. 2001) (citing *Fid. & Cas. Co. v. Cope*, 462 So.2d 459, 460 (Fla. 1985)).

iv. California

California law requires the insurer to place the interests of the insured on parity with its own. The duty of good faith includes a duty to settle that overrides any silence in the insurance policy regarding

²⁵ Arguably, a demand above the primary policy limits might still be effective, if the primary insurer is notified that the policyholder or excess insurer is prepared to pay the settlement amount excess to primary limits. See *State Farm Lloyds Ins. Co. v. Maldonado*, 963 S.W.2d 38 (Tex.1998).

²⁶ If an insurer has accepted the defense of an insured facing multiple claims or the defense of an insured being sued by multiple claimants, the insurer's duty to accept a reasonable settlement offer is examined by viewing each claim separately. See Russell H. McMains, *Updating the Stowers Minefield*, University of Houston Law Foundation Advanced Insurance and Tort Claims, June 2006.

settlement; an insurer must settle an appropriate case despite the fact that the express terms of the policy do not impose such a duty. *Crisci v. Sec. Ins. Co.*, 426 P.2d 173 (Cal. 1967). As a general rule, “in determining whether to settle the insurer must give the interests of the insured at least as much consideration as it gives to its own interests.” *Id.* The corollary of this rule is that “the insurer must conduct itself as though it alone were liable for the entire amount of the judgment.” *Johansen v. Cal. State Auto. Ass'n Inter-Ins. Bureau*, 538 P.2d 744 (Cal. 1975). Thus, the insurer’s decision regarding settlement should be neutral and detached, focusing on reasonableness alone: “Such factors as the limits imposed by the policy, a desire to reduce the amount of future settlements, or a belief that the policy does not provide coverage should not affect a decision as to whether the settlement offer in question is a reasonable one.” *Id.* at 748–49. The rationale for the rule is to prevent a conflict of interest from working against the policy holder:

[W]hen a settlement within policy limits is offered by claimant, the previously parallel interests of the assured and carrier diverge, and a conflict of interest arises, for while it is invariably to the assured's financial interest to settle within policy limits, settlement is only to the carrier's financial interest when the relationship between settlement offer and policy limits is mathematically favorable in the light of the probabilities of winning or losing the suit.

Merritt v. Reserve Ins. Co., 34 Cal.App.3d 858, 869-70 (Cal. Ct. App. 1973).

Under California law, an insurer will be liable for a judgment in excess of the policy limits where “a prudent insurer without policy limits would have accepted the settlement offer.” *Crisci*, 426 P.2d at 176. Criteria such as “actual dishonesty, fraud, or concealment” on the part of the insurer are not a prerequisite to recovery. *Id.* Rather, “liability may exist when the insurer unwarrantedly refuses an offered settlement where the most reasonable manner of disposing of the claim is by accepting the settlement.” *Id.* at 176–77.

v. New York

Unlike states such as California, New York does not require that the insurer place the insured’s interests on parity with its own. It has sought to balance the countervailing policies of (1) respecting the insured’s legitimate expectation that the insurer will act in its best interests and (2) the insurer’s legitimate contract expectations (i.e., the bargained for policy limits) and control of the defense by imposing liability on the insurer for an excess judgment only in cases of “gross negligence.” *Pavia v. State Farm Mutual Automobile Ins. Co.*, 626 N.E.2d 24, 27 (N.Y. 1993). In other words, the plaintiff “must establish that the defendant insurer engaged in a pattern of behavior evincing a conscious or knowing indifference to the probability that in insured would be held personally accountable for a large judgment if a settlement offer within the policy limits were not accepted.” *Id.* at 27–28.

The “gross negligence” standard does not completely relieve the insurer of any responsibility to communicate settlement negotiations and demands to the insured. Certainly there is “no unqualified duty to inform the insured of settlement offers such that the failure to do so establishes liability as a matter of law.” *Smith v. General Accident Ins. Co.*, 697 N.E.2d 168, 171 (N.Y. 1998). Yet, the failure of an insurer to communicate with the insured about settlement offers and negotiations is evidence of bad faith where an insurer would ordinarily do so or customarily does so. *Id.* at 172. Thus, even in states like New York an insurer should follow industry practice or custom in deciding whether to

involve the insured in the settlement process in order to avoid liability for an excess judgment down the road.

vi. Ohio

Under Ohio law, the insurer's obligations regarding settlement are tied to its duty to act in good faith, and an insurer must "accept reasonable settlements." *Hoskins v. Aetna Life Ins. Co.*, 452 N.E.2d 1315, 1319 (Ohio 1983) (citing *Hart v. Republic Mut. Ins. Co.*, 87 N.E.2d 347 (Ohio 1949)). Ohio courts have long held that the "reasonable justification" standard is the standard for bad faith. *Zoppo v. Homestead Ins. Co.*, 644 N.E.2d 397, 399–400 (Ohio 1992) ("over the past forty-five years this court has consistently applied the "reasonable justification" standard to bad faith cases.") (citing *Hart*, 87 N.E.2d at 349) ("The conduct of the insurer must be based on circumstances that furnish a reasonable justification therefore."). And under Ohio law, intent is not an element of bad faith. *Id.* The rationale for the affirmative obligations placed upon an insurer regarding settlement is the disparity in bargaining power between the parties and the often vulnerable position in which a policy holder may find himself when in a position of economic difficulty. *Hoskins*, 452 N.E.2d at 1320 (citing *Motorist Mut. Ins. Co. v. Trainor*, 294 N.E.2d 894 (Ohio 1973)).

A breach of the duty to act in good faith by refusing to settle without a reasonable justification gives rise to a cause of action in tort. Although an excess judgment is required to sustain the cause of action, Ohio courts have held that an insurer can remain liable regardless of whether it pays the excess judgment. *See, e.g., Carter v. Pioneer Mut. Cas. Co.*, 423 N.E.2d 188, syllabus ¶¶ 1, 2 (Ohio 1981) (adopting the majority "judgment rule"²⁷); *Logan v. Allstate Ins. Co.*, 865 N.E.2d 57 (Ohio App. 2006). This holding is predicated upon the fact that an excess judgment constitutes harm in itself, in part because it potentially impairs the insured's credit and may cloud the title to the insured's property. *Logan*, 865 N.E.2d 57, at ¶ 25.

vii. Colorado

Colorado law also discusses the insurer's responsibilities regarding settlement in the context of the obligation to act in "good faith" rather than in terms of a distinct "duty" to reasonably pursue settlement. It is similar to that of California or Florida insofar as it does not require evidence of intentional misconduct, dishonesty, fraud, or concealment to support a finding of bad faith stemming from the insurer's refusal to settle. *See Farmer's Group, Inc. v. Trimble*, 691 P.2d 1138 (Colo. 1984). Under Colorado law, where an insurer undertakes the defense of its insured against a third-party claim, the "insurance company stands in a position similar to that of a fiduciary." *Id.* at 1141. Given this "quasi-fiduciary" relationship, the standard of conduct to which an insurer is held is that of ordinary negligence, or "reasonableness under the circumstances." *Id.* at 1142. But unlike jurisdictions such as California, Colorado does not recognize a cause of action for bad faith absent actual exposure of an insured to an excess judgment. *Id. Cf. LensCrafters, Inc. v. Liberty Mut. Fire Ins. Co.*, 2008 WL 410243, at *3 n.3 (N.D. Cal. 2008).

f. Mediation

²⁷ There are two general rules that courts have adopted with regard to this issue – the "judgment rule" and the "payment rule." Under the "judgment rule" an entry of excess judgment alone can be sufficient to sustain a cause of action for bad faith, while under the "payment rule" if the insured did not or cannot pay out money to satisfy the judgment there can be no recovery for bad faith under the rationale that the insured was not harmed. *See Carter*, 423 N.E.2d at 148–49.

A carrier or coverage counsel's role in mediation of an underlying claim can be complicated. Generally, there are two bases for conflicts between the insurer and the insured in mediation: either there is a conflict over the scope of the insurer's duty to defend or there is an unresolved issue regarding the insurer's indemnity obligation. In either event, the insured believes that the insurer is not providing the full measure of protection afforded under the liability policy.²⁸ One of the most important things for the carrier or coverage counsel to know going into a mediation is whether the insured has a right to consent to the settlement, or if the carrier has the full authority to settle the case without the insured's consent. Further, it is important to remember that a large part of mediation is "going through the process" and making all participants feel like they are working together to reach the settlement. In some cases, the dynamics of the tripartite relationship can throw the mediation process off balance, and the carrier can be perceived as a "roadblock" to settlement. In order to conduct a productive and successful mediation, all participants should be able to identify and appreciate the varied interests represented by each party.²⁹

From the outset of a mediation, the representative of the insurance company, whether it is an adjuster or coverage counsel or both, should keep in mind both the priority of issues on the defense agenda and the coverage issues at play in each of the defense's issues, and then consider whether reordering those priorities would make the mediation more productive. For example, in some cases it may be more productive to discuss the claims that may not be covered under the liability policy first because uncovered claims can be used as leverage against the plaintiff's counsel. On the other hand, if the defense is not willing to concede that certain claims may not be covered, it may be more beneficial to focus on the merits of the underlying case and see if the entire case can be settled in a cost effective manner that is beneficial to all the parties. Typically, a mediation will be more productive if the insured and insurer can work out apportionment issues prior the mediation. If this can be accomplished, the negotiations can be focused on the underlying case.³⁰ If this cannot be accomplished, it is important for coverage counsel to consider the priority and structure of the negotiations and the order in which the two disputes, the underlying case and the coverage dispute, should be discussed.

Regardless of the order the issues in the case are addressed, most insureds and insurers agree on at least one important aspect of mediation – the two must show a unified front for the purposes of the liability case in the open session.³¹ Coverage counsel should allow defense counsel to lead the defense's opening statement. The defense counsel can use this opportunity with all parties present to speak directly to the plaintiff, request additional information from the plaintiff, clarify certain points, highlight the weaknesses in the plaintiff's case, and note the defense's strong points. The insurer and insured forming a united front in the open session is not only a wise strategy but plays into the established principle that the insurer cannot do anything to sabotage the insured's defense.

g. The Insurer's Rights to Reimbursement

²⁸ See Samuel F. Barnum and James Laflin, *Resolving the Trilemma Within the Cumis Triangle: A Progressive Negotiation Strategy*, 4 Cal. L. & Reg. Rep. 68 (1998).

²⁹ *Id.*

³⁰ *Id.*

³¹ See Samuel F. Barnum and James Laflin, *Resolving the Trilemma Within the Cumis Triangle: A Progressive Negotiation Strategy*, 4 Cal. L. & Reg. Rep. 68 (1998).

It is a universal principle that the duty to defend is broader than the duty to indemnify. *See, e.g., Automobile Ins. Co. of Hartford v. Cook*, 850 N.E.2d 1152, 1155 (N.Y. 2006) (“It is well settled that the duty to defend is broader than the duty to indemnify. Indeed, the duty to defend is exceedingly broad and an insurer will be called upon to provide a defense wherever the allegations of the complaint suggest a reasonable possibility of coverage.”)(citations and internal quotations omitted); *Perkins v. Allstate Ins. Co.*, 63 F.Supp.2d 1164, 1169 (C.D. Cal. 1999) (noting that the duty is “a well established precept of insurance law”). Thus there are many circumstances in which an insurer must defend a claim even though ultimately it would have no duty to indemnify its policy holder for any settlement or judgment arising out of the claim.

Because of the breadth of the defense obligation, insurers at times take a safe approach by defending cases that they believe may not be covered by the duty to defend. In some cases, the insurer then attempts to recover the cost of this defense from the policy holder. Courts have taken different positions on the question of whether an insurer may seek reimbursement for defense costs where it is determined that the insurer has no duty to defend and the insurer has attempted to reserve its rights through a “reservation” letter. The question is not yet settled in some jurisdictions and the issue remains a timely one. The Pennsylvania Supreme Court recently (November, 2008) granted a petition for review of the issue in *American and Foreign Ins. Co. v. Jerry’s Sport Center, Inc.*, No. 399 MAL 2008, 2008 WL 4926696 (Pa. 2008), and will soon rule on it.

States take different positions on the nature of circumstances that would allow an insurer to recover defense costs. The majority view is that an insurer is entitled to reimbursement of defense costs where “(1) the insurer did not have a duty to defend, (2) the insurer timely and expressly reserved its right to recoup defense costs, and (3) the insured either remains silent in the face of the reservation of rights or accepts the insurer’s payment of defense costs.” *General Agents Ins. Co. of America, Inc. v. Midwest Sporting Goods Co.*, 828 N.E.2d 1092, 1104 (Ill. 2005). The minority view, followed by jurisdictions such as Illinois, is to add the additional requirement that there be an express provision regarding reimbursement in the insurance contract. *Id. See also, e.g., Cincinnati Ins. Co. v. Grand Pointe, LLC*, 501 F.Supp.2d 1145, 1161 (E.D. Tenn. 2007) (discussing the two positions).

There is also some case law discussing the issue of whether a finding that no duty to defend exists applies retroactively to the beginning of the litigation, thus allowing an insurer to recover all defense costs incurred from the outset. California seems to have most thoroughly discussed the issue, and the answer hinges on whether there ever existed the “potential for coverage.” Under California law, a court is permitted to determine, in hindsight, whether there ever was a duty to defend. *Scottsdale Ins. Co. v. MV Transportation Co.*, 115 P.3d 460, 468 (Cal. 2005). If it is determined that a duty to defend never arose, then the insurer may be able to recover defense costs from the outset of the defense. *Id.* On the other hand, where even the potential for coverage existed, a finding that no duty to defend exists only applies prospectively, and not retroactively. *Buss v. Superior Court*, 939 P.2d 766, 773 (Cal. 1997). In this situation, the only defense costs that could be recovered are those incurred after the duty to defend is extinguished. *Id.*

Insurers have attempted to recover defense costs under more novel theories, such as equitable subrogation, and quantum meruit or unjust enrichment, but frequently to no avail. *See, e.g., Texas Association of Counties County Gov’t Risk Mgmt. Pool v. Matagorda County*, 52 S.W.3d 128, 133–34 (Tex. 2000) (summarizing cases on the issue). The subrogation argument generally fails because an insurer is not permitted to subrogate against its own insured—it would create a situation where the carrier sues the policy holder, fostering distrust and conflict in the insurer-insured relationship. *Id.*

Quantum meruit and unjust enrichment theories are likewise rejected in jurisdictions such as Texas, where the insurer may only be reimbursed for defense costs in the event that the insured consents to this right. *Id.*

In the context of the tripartite relationship, defense counsel should be aware of whether, once a defense is undertaken, the insured could be required to pay defense costs. In jurisdictions such as California, where there is a real possibility that the insured may have to pay all defense costs from the beginning of the defense, it would be prudent to include the insured in the decision making process, inform the insured of billing practices and policies (imposed by the insurer or otherwise), and allow the insured to have some input regarding strategy. Such steps may prevent a subsequent dispute over the amount of defense costs that the insured may have to pay back to the insurer. In jurisdictions such as Illinois, where the insured is not required to reimburse the insurer for defense costs, there are other considerations. For example, where there is uncertainty over coverage, the insurer will generally undertake a defense of the insured under a reservation of rights and also file a declaratory judgment action regarding coverage. Defense counsel may be under pressure to divulge discovered information quickly regarding the underlying claim so that the declaratory judgment action may proceed as soon as possible. But as discussed above, defense counsel must be careful not to reveal confidential or privileged information to the insurer, even if it would help the insurer to avoid coverage.

4. CONCLUSION

The tripartite relationship can have its difficulties, but it generally behooves all parties for the insurer to maintain the control of the defense to a degree. In many cases, the goals of the insured and insurer are perfectly aligned. In those cases in which the insurer defends under a reservation of rights, the insured can take comfort in the fact that defense lawyers are by and large trustworthy and ethical and follow the mandates of the law and the Professional Rules of Conduct to zealously represent the insured's interest, and only the insured's interest.