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Claims Handling Conflicts

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Claims handling is complicated by conflicts of interest. Conflicts of interest can arise between the insurer and insured and between named insureds and additional insureds. Claims between insureds include claims between an insured as indemnitor and its indemnitee under contractual liability coverage between employers and employees, among a corporation and its directors and officers.

These conflicts present issues and choices for a claims handler. When a conflict between insureds or insurer and insured exists, should the insurer's file be split for handling? When is an insurer required to provide independent counsel? Does every reservation of rights by the insurer trigger a right to independent counsel on the part of the insured? Should the reservation of rights which created the conflict ever be withdrawn? Even if the insured has no legal right to independent counsel, are there times when it nonetheless might be a good idea to let the insured have independent counsel?

Conflict Between the Insurer and Its Insured

The most frequent conflict encountered in liability claims handling is the conflict between the insurer and the insured. This is a conflict about the rights of the insured and insurer under the insurance policy. One way this conflict is expressed or framed is with a reservation of rights by the insurer, when it undertakes to defend the insured under a reservation of rights. The insurer does have the right and duty to defend the action. But many jurisdictions find that the existence of a reservation or rights – at least certain types of reserved rights – creates a conflict. In the past insurers asserted their contractual right to control the defense and did so. Many courts have addressed this problem by requiring appointment of independent counsel to represent the insured. Some states let the insurer pick an independent attorney, but many let the insured pick the independent attorney. Some courts address the problem by imposing a higher duty of good faith upon the insurer.

The duty to defend is set out in the insuring agreement of the commercial general liability form. "We [the insurer] will have the right and duty to defend the insured against 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' [or 'personal and advertising injury'] to which this insurance

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does not apply." However, "Our right and duty to defend ends when we have used up the applicable limit of insurance in the payment of judgments or settlements . . . ." ISO Commercial General Liability Form, CU 00 01 04 13, page 1.

This says nothing about the insured having a right to defend itself, or to insist that it can pick defense counsel and control the defense, or that the insurer must pay for defense counsel selected by the insured. Those rights or obligations come from case law.

Some jurisdictions find that the insurer has a duty to defend but that the insured can select counsel and control the defense. Other states find that in a conflict situation the insurer has no duty to defend, cannot defend, and instead must reimburse defense expense incurred by the insured's selected counsel.

In California the leading case on this point is *San Diego Navy Federal Credit Union v. Cumis Ins. Society,* 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984). However, many states decided this issue before California did. E.g., *Prashker v. United States Guar. Co.*, 1 N. Y. 2d 584, 136 N. E. 2d 871, 154 N. Y. S. 2d 910 (1956); *Maryland Casualty Co. v. Peppers*, 64 Ill.2d 187, 355 N.E.2d 24 (1976); *Employers' Fire Ins. Co. v. Beals*, 103 R. I. 623, 240 A. 2d 397 (1968).

Under California law, under the *Cumis* decision, a carrier is required to provide independent counsel when there is a conflict of interest created by a reservation of rights letter. More specifically, independent counsel must be provided for the insured when resolution of a third party claim will bear directly on the outcome of the coverage dispute between the insurer and the insured. *Cumis, supra*, 162 Cal.App.3d at 364. A conflict exists where the *nature* of the insured's conduct is the subject of both the third party action and the coverage dispute that precipitated the reservation of rights. For example, in the *Cumis* case, an employee sued the insured for wrongful termination of employment and for intentional infliction of emotional distress, and sought compensatory and punitive damages. Coverage for intentional acts and punitive damages was excluded. The court held that defense on a reservation of rights basis created a disqualifying conflict of interest because the insured would want to try to have any judgment against the employer rest on findings that the employer intended to injury the employee (exclude it from coverage) while the insured would want any judgment to rest on findings that it had no such intent (i.e., covered). *Cumis, supra*, 162 Cal.App.3d at 364-65.

The most frequently encountered conflicts of interest are those such as this in the *Cumis* case, where there is an intent issue. The ultimate outcome in that type of case can go one of three ways. First, the trial may result in a defense verdict, in which case neither the insured nor the insurer has to pay a judgment. Second, a plaintiff verdict on an accidental injury theory, in which case the insurer has to pay the judgment and the insured does not. Third, a defense verdict based upon an intentional injury theory, in which case the insured has to pay the judgment and the insurer does not. The possibility that defense counsel could "steer" the case between the latter two results or "shape the defense" is the possibility that gives rises to the conflict of interest articulated in the *Cumis* case. *Cumis*, 162 Cal. App. 3d at 368, 208 Cal. Rptr. at 496.

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The Nevada Supreme Court recently followed *Cumis*. Nevada requires an insurer to provide independent counsel when a conflict of interest arises between the insurer and insured. The insurer and the insured are dual clients of insurer-appointed counsel. When the insured and the insurer have opposing legal interests, Nevada law requires insurers to allow their insureds to select their own independent counsel and pay for such counsel. An insurer is only required to provide independent counsel when the insured's and the insurer's legal interests actually conflict. A reservation of rights letter does not create a *per se* conflict of interest. *State Farm Mut. Auto Ins. Co. v. Hansen*, 357 P.3d 338 (Nev. 2015).

In *Public Service Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 401, 442 N.Y.S.2d 422, 425 N.E.2d 810 (1981) the insured dentist was sued for sexual abuse of a patient. The court found that there was a conflict since the insurer would be liable only upon some of the grounds for recovery asserted and not upon others (The issue there was whether the injury was intentional). Therefore, the insured was entitled to defense by an attorney of his own choosing, whose reasonable fee is to be paid by the insurer. The court stated that not every conflict of interest requires independent counsel. "Independent counsel is only necessary in cases where the defense attorney's duty to the insured would require that he defeat liability on any ground and his duty to the insurer would require that he defeat liability only upon grounds which would render the insurer liable. … On the other hand, where multiple claims present no conflict -- for example, where the insurance contract provides liability coverage only for personal injuries and the claim against the insured seeks recovery for property damage as well as for personal injuries -- no threat of divided loyalty is present and there is no need for the retention of separate counsel. This is so because in such a situation the question of insurance coverage is not intertwined with the question of the insured's liability." *See Prashker v. United States Guar. Co.*, 1 N. Y. 2d 584, 136 N. E. 2d 871, 154 N. Y. S. 2d 910 (1956) (if there was a conflict, insured could select defense counsel where some of plaintiff's theories of liability would be excluded by an exclusion concerning flying in violation of terms of a pilot's certificate and instrument flying, and some theories would not be excluded).

In *Maryland Casualty Co. v. Peppers*, 64 Ill.2d 187, 355 N.E.2d 24 (1976) a property owner shot an intruder who was fleeing. The plaintiffs sued the property owner for assault with the shotgun, negligent and careless discharge of the shotgun and willful and wanton firing of the shotgun at Mims. The courts observed that Peppers was charged with covered and uncovered conduct. St. Paul had a duty to defend. The court found an unresolved conflict of interest between Peppers and St. Paul. Because of that conflict the court held that an attorney could not represent both St. Paul and Peppers, without full disclosure by the attorneys to Peppers. Or St. Paul could waive its defense of non-coverage by the policy and defend without reservation and the conflict would be removed. Without either of those, Peppers had the right to be represented by an attorney of his choice who would have the right to control the conduct of the case. St. Paul must reimburse that reasonable cost. *See Thornton v. Paul*, 74 Ill. 2d 132, 384 N. E. 2d 335 (1978).

In *Tank v. State Farm Fire & Casualty Co.*, 105 Wash.2d 381, 715 P.2d 1133 (1986), the court held that, when an insurer defends under a reservation of rights, an "enhanced" standard of good faith is applicable to judicial scrutiny of the insurer's actions.

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What Conflicts Give Rise to a Right to Independent Counsel?

Courts take differing views on what reservations of rights create a conflict of interest.

Some courts hold the view that any reservation of rights creates a conflict of interest. *Moeller v. American Guar. and Liability Ins. Co.*, 707 So. 2d 1062 (Miss. 1996).

Some courts find to the contrary that a reservation of rights creates a conflict of interest in any case. *Finley v. Home Ins. Co.*, 90 Hawai`i 25, 975 P. 2d 1145, 1151-52 (1998) ("Upon balancing the respective pros and cons of suggested solutions to the issue, we are convinced that the best result is to refrain from interfering with the insurer's contractual right to select counsel and leave the resolution of the conflict to the integrity of retained defense counsel.") (footnote omitted). But on the issue of control, *Finley* holds that the "insurer's desire to limit expenses must yield to the attorney's professional judgment and his or her responsibility to provide competent, ethical representation to the insured." *Id.*

Many courts hold that a conflict exists requiring independent counsel where the nature of the insured's conduct is the subject of both the third party action and the coverage dispute that precipitated the reservation of rights. For example, in the *Cumis* case, coverage for negligently caused injury versus intentionally caused injury. The corollary to that is that there may be reservations of rights that do not create a conflict that requires independent counsel.

Under California law, where the reservation of rights is based on coverage disputes which have nothing to do with the issues being litigated in the third party action, there is no conflict of interest requiring independent counsel. For instance, a dispute as to whether the party being sued is "an insured" under the policy may be extrinsic to an independent of the issues to be decided in the third party action. The party being sued and the insurance carrier have identical interests in proving that the insured is not at fault. *McGee v. Superior Court*, 176 Cal. App. 3d 221, 227-28, 221 Cal. Rptr. 421, 424 (1985) (auto accident lawsuit; resident relative exclusion did not create a *Cumis* conflict).

"A mere possibility of an unspecified conflict does not require independent counsel. The conflict must be significant, not merely theoretical, actual, not merely potential." *Dynamic Concepts v. Truck Ins. Exch.*, 61 Cal. App. 4th 999, 1007, 71 Cal. Rptr. 2d 882, 887 (1998).

Claim for Punitive Damages

Some policies have express exclusions for punitive damages. In some states public policy prohibits insurability of punitive damages, as it does, for example, in California and New York. And in some states punitive damages may not be viewed as damages because of bodily injury or property damage so as to come within the insuring agreement. Does a reservation of the right to deny coverage for and not to pay punitive damages create a conflict of interest that entitles the insured to independent counsel? The answer varies by state and by facts.

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Under California Civil Code '2860, the mere fact that there is a claim for punitive damages, or that the damages may exceed the policy limit does not create a conflict of interest.

In New York some cases indicate that a claim for punitive damages may entitle the insured to independent counsel. *Hartford v. Village of Hempstead*, 48 N. Y. 2d 218 (1979) (two peace officers sued for civil rights violations were entitled to defense of the punitive damage issue by an attorney selected by then or the municipality but paid for by the insurer).

In *Nandorf v. CNA Ins. Cos*., 134 Ill. App. 3d 134, 479 N. E. 2d 988, 88 Ill. Dec. 968 (1st Dist. 1985), a substantial portion of the potential liability involved punitive damages. The Complaint sought $5,000 in compensatory damages and $100,000 in compensatory damages. The court held that because there was a comparatively small amount of compensatory damages involved, the insurer may have been inclined to provide a "less than vigorous" defense for the punitive damages allegations. The court stated that "finding that a conflict of interest existed in the instant case is not meant to imply than an insured is entitled to independent counsel whenever punitive damages are sought in the underlying action." But in *Tews Funeral Home, Inc. v. Ohio Cas. Ins. Co.,* 832 F. 2d 1037 (7th Cir. 1987) the court found no conflict as to defense of an antitrust lawsuit where the amount of compensatory damages was large and not small by comparison with the amount of punitive damages sought.

Reservation to Pay Only Some Items of Damages

If there is a reservation of rights not to pay certain items of damages, while other items of damages may be covered, this type of reservation of rights does not create a conflict of interest giving rise to the right to Cumis counsel. *Blanchard v. State Farm Fire & Casualty Co.* (1991) 2 Cal. App. 4th 345, 350, 2 Cal. Rptr. 2d 884 (reservation of rights not to pay for damages attributable to work of the insured, product of the insured and impaired property did not create a *Cumis* conflict). The court reasoned that the only coverage issue involved only damages, and that defense counsel had no incentive to attach liability to the insured. It was to the advantage of both the insurer and the insured to minimize the insured's liability.

But sometimes one must dig deeper. In *Pepper Const. Co. v. Casualty Ins. Co.,* 145 Ill. App. 3d 516, 495 N. E. 2d 1183, (1986) the insured was building a store. The roof collapsed from weight of snow. The owner sued for the cost to repair the damage to the roof and damage to the contents. The insurer agreed that it covered for damage to the contents, but disputed coverage for the cost to repair the work of the insured. The insurer argued that its interest was aligned with the insured contractor's interest in defending against the owner's claim, and that no issue would be litigated that would affect coverage. However, the court noted that the insured would want a finding that it was vicariously liable for work performed by a subcontractor, in which case it was covered; in contrast the insurer would want finding that plaintiff is liable based on work it performed, so that it was not covered. This was an issue in the litigation because the owner had sued the contractor, but had also sued the architect, steel supplier and contractor, steel joist manufacturer, and steel installer and contractor. So, the liability of all would be determined in the suit. So, the conflict existed in that lawsuit.

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Demand Exceeds Limits

Under California Civil Code ' 2860, no conflict of interest is deemed to exist solely because an insured is sued for an amount in excess of the insurance policy limits." Cal. Civ. Code §2860 (b).

Agency and Permissive Use

In *Murphy v. Urso*, 88 Ill.2d 444, 430 N.E.2d 1079 (1981) Murphy was a passenger in a van. The driver, Clancey, was speeding, and struck several parked cars. Murphy sued for Clancey, and the van's alleged owners, Urso (operator of the Edgewater Pre-school), and Edgewater Primary School, Inc. Murphy alleged that Clancey was negligent and that he was acting as the agent of Urso and Edgewater. She also alleged Urso and Edgewater's willful / wanton / negligent entrustment of the van to Clancey.

Here there was a conflict between the named insured – a preschool - and an alleged permissive user of a bus. The preschool would try to show that the driver did not have permission: that he had been discharged or in any event was not operating within the scope of his employment, or that he had no explicit or implicit approval to use the bus. This would exonerate the preschool. But the driver would want to prove that he did have permission to use the bus, and spread the liability to the schools.

The insurer's interests conflicted with the driver's. Liability on the driver seemed clear. So, the driver's interest lay in siding with the plaintiff and shifting liability to the preschool so that the insurance would pay any judgment. But the insurer's interest lay in separating the driver from the schools so that he would bear the entire liability, and none would fall on the insurer. *Compare Clemmons v. Travelers Ins. Co.*, 88 Ill. 2d 469, 430 N. E. 2d 1104 (1981) (auto accident caused bodily injury to plaintiff; only driver and not employer / auto owner was sued, so that permission was not an issue in the underlying case; therefore the insurer had a duty to defend – there was no conflict preventing that defense; and therefore the court applied the Illinois estoppel rule because the insurer had failed to defend).

Right to Seek Reimbursement

An insurer's reservation of the right to seek reimbursement of defense costs allocable to uncovered claims is not an issue that will be litigated in the underlying action and, therefore, does not by itself trigger the insurer's duty to appoint independent counsel. *James 3 Corp. v. Truck Ins. Exchange,* 91 Cal.App.4th 1093, 1108-1109, 111 Cal. Rptr. 2d 181 (2001).

Who Selects Independent Counsel?

In many states the insured selected independent counsel. E. g. *San Diego Navy Federal Credit Union v. Cumis Ins. Society,* 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984); *Prashker v. United States Guar. Co.*, 1 N. Y. 2d 584, 136 N. E. 2d 871, 154 N. Y. S. 2d 910 (1956); *Maryland Casualty Co. v. Peppers*, 64 Ill.2d 187, 355 N.E.2d 24 (1976).

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In California a policy may set forth some other provision. "An insurance contract may contain a provision which sets forth the method of selecting that counsel consistent with this section." Cal. Civ. Code §2860 (a). This seems to be the result in most decisions that have reached the issue. See *Joseph v Markovitz* (1976) 27 Ariz. App. 122, 551 P. 2d 571 (medical malpractice action; insurer had to pay for independent counsel selected by third insured where two insureds sued a third for indemnity under a physician's partnership agreement; offer to waive control of the defense of that third insured was not sufficient).

In *Yeomans v. Allstate Ins. Co.*, 130 N.J. Super. 48, 54, 324 A.2d 906, 909 (App. Div. 1974) the insurer appointed separate counsel for two insured defendants who had conflicting interests. The court found no breach in this case. "In short, under the circumstances here, we believe that Allstate fulfilled its duty in the matter of representation for its insureds by selecting independent outside counsel for each of them." Note this was a case concerning a conflict among insureds, not between the insurer and insured.

Some cases hold that the insured be given a choice. "When such a conflict of interest arises, the insured must be informed of the nature of the conflict and given the right either to accept an independent attorney selected by the insurer or to select an attorney himself to conduct his defense." *Brohawn v Transamerica Ins. Co.,* 276 Md. 396, 414-15, 347 A. 2d 842 (1975).

Some decisions let the insured pick counsel, subject to approval by the insurer, that approval not to be unreasonably withheld. "Because the insurer has a legitimate interest in seeing that any recovery based on finding of negligence on the part of its insured is kept within reasonable bounds, and since the total expense of this defense is to be assumed by the insurer under its promise to defend, we believe that in each of the above two suggestions the engagement of an independent counsel to represent the insured should be approved by the insurer. Such approval, however, should not be unreasonably withheld." *Employers' Fire Ins. Co. v. Beals*, 103 R. I. 623, 240 A. 2d 397 (1968).

Who Has the Duty to Advise the Insured of the Conflict?

In California both the defense attorney and the insurer have the duty to advise the insured of the conflict. *Cumis* held that ethical rules "impose upon lawyers hired by the insurer an obligation to explain to the insured and the insurer the full implications of joint representation in situations where the insurer has reserved its rights to deny coverage." *Cumis, supra,* 162 Cal. App. 3d at 375, 208 Cal. Rptr. at 496. California Civil Code section 2860 (a) provides that when " a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel." That would appear to require notice be provided by the insurer.

In Illinois, originally the duty was that of the defense attorney to advise the insured. *Peppers v. Maryland Casualty.* But in *United States Fid. & Guar. Co. v. Continental Cas. Co.*, 153 Ill. App. 3d 185, 505 N. E. 2d 1072, 106 Ill. Dec. 281 (1st Dist. 1987). But in *Royal Ins. Co. v. Process Design*

Associates, Inc., 221 Ill. App.3d 966, 582 N. E. 2d 1234 (1991) the court indicated that the insurer had to advise the insured of the conflict. The court held that estoppel arose in part because the insurer failed to advise the insured of the conflict in interest. "Consequently, we hold that, based upon Royal's failure to properly reserve its rights and its failure to advise Process of the conflict of interest, Royal is estopped from now claiming that it is not obligated to indemnify Process."

In *Brohawn v Transamerica Ins. Co.,* 276 Md. 396, 347 A. 2d 842 (1975), the court held that when a conflict of interest between the insurer and the insured arises, the insured must be informed of the nature of the conflict and give the insured the choice of either accepting an independent attorney selected by the insurer, or selecting his own attorney with the reasonable costs of such attorney for the defense assumed by the insurer. Inasmuch as there was no defense counsel involved, this appears to put that duty on the insurer.

How Much Must an Insurer Pay Independent Counsel?

The *reasonable fee* of independent counsel is to be paid by the insurer. *Public Service Mut. Ins. Co. v. Goldfarb*, 53 N.Y.2d 392, 401, 442 N.Y.S.2d 422, 425 N.E.2d 810 (1981). Most states follow this type of rule. Insurers typically assert that the rates they pay their panel counsel are reasonable rates. Insureds generally assert that these rates are not reasonable. Insureds often will assert that panel counsel's rates are lower than market rates because of the volume of work they receive from the insurer as panel counsel.

In California, the Legislature passed a statute, Civil Code section 2860 to address compensation of independent counsel. Civil Code section 2860, subdivision (c) states that: "The insurer's obligation to pay fees to the independent counsel selected by the insured is limited *to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended*." (emphasis added). Alaska has a similar statute: Alaska Statutes Sec. 21.96.100 (Appointment of independent counsel; conflicts of interest; settlement); see also Guam Code Annotated 22 GCA § 12111 (Conflict of Interest Between Insured and Insurer).

Under the California statute, it only applies if there is a reservation of rights. If there is no reservation of rights, either because the insurer denied or it did not reserve rights, then the statute will not apply to limit the rates. *County of San Bernardino v. Pacific Indemnity Co.,* 56 Cal.App.4th 666, 692, 65 Cal. Rptr. 2d 657 (1997) (section 2860 was inapplicable to a dispute over the rate the insured's counsel was to be paid, the insurer had conceded "'no Cumis type conflict arose out of' its reservation of rights." A practical problem for insurers is fees incurred by the insured between the time of notice and the time of the coverage position letter. Many insurers will advise of the panel rate in first acknowledging the case and then apply that rate to those interim fees if the end result is a defense under a reservation of rights.

How Is a Dispute Regarding Rates and Billing Resolved?

California Civil Code section 2860 (b) provides for arbitration to resolve the billing rate issue. "Any

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dispute concerning attorney's fees not resolved by these methods shall be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties to the dispute." Cal. Civ. Code sec. 2860 (c).

Absent a statutory mandate or contractual agreement for arbitration, however, it would seem that litigation would be the procedure to resolve such disputes. E.g. *N. Sec. Ins. Co. v. R.H. Realty Tr.,* 25 Mass. L. Rep. 185 (2009) (insurer sued insured and the insured's independent counsel for a declaratory judgment that $ 150 was a reasonable hourly rate; the firm counterclaimed for payment of counsel's time at $ 225 an hour; expert testimony and the court's knowledge showed $ 350 was a reasonable hourly rate).

What Rights Does an Insurer Have to Insist on Qualification of Independent Counsel?

California Civil Code section 2860, subdivision (c) sets out certain requirements for independent counsel that an insurer can insist on: "When the insured has selected independent counsel to represent him or her, the insurer may exercise its right to require that the counsel selected by the insured possess certain minimum qualifications which may include that the selected counsel have (1) at least five years of civil litigation practice which includes substantial defense experience in the subject at issue in the litigation, and (2) errors and omissions coverage." Cal. Civ. Code § 2860; see Alaska Statutes Sec. 21.96.100 ("at least four years of experience in civil litigation, including defense experience in the general subject area at issue in the civil action, and malpractice insurance").

In states that allow the insurer to select independent counsel, the insurer can seek appropriately qualified counsel. The insured may want some input in that circumstance to be comfortable with the representation. In states that allow the insurer to consult regarding selection of counsel, that process would allow the insurer to assert the need for some level of qualification. *Employers' Fire Ins. Co. v. Beals*, 103 R. I. 623, 240 A. 2d 397 (1968). The restraint of not unreasonably withholding consent would seem to provide an appropriate standard to allow the insurer to insist on a reasonably qualified defense attorney.

Can the Insured Waive Independent Counsel?

The insured can waive independent counsel. Cal. Civ. Code § 2860 (a) ("If the provisions of a policy of insurance impose a duty to defend upon an insurer and a conflict of interest arises which creates a duty on the part of the insurer to provide independent counsel to the insured, the insurer shall provide independent counsel to represent the insured unless, at the time the insured is informed that a possible conflict may arise or does exist, the insured expressly waives, in writing, the right to independent counsel.")

Subdivision (e) of the statute provides a form of waiver: "The insured may waive its right to select independent counsel by signing the following statement: 'I have been advised and informed of my right to select independent counsel to represent me in this lawsuit. I have considered this matter fully and freely waive my right to select independent counsel at this time. I authorize my insurer to select a defense attorney to represent me in this lawsuit.' "Cal. Civ. Code sec. 2860 (e).

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Generally, potential conflicts may be waived. In *Employers' Fire Ins. Co. v. Beals*, 103 R. I. 623, 240 A. 2d 397 (1968) the court noted that if the insured "appreciates the conflict of interests which arises for attorneys who are asked by the insurance company to provide a defense for John in this action and nonetheless expresses willingness to accept the services of the insurance attorneys in his defense, the significance of the conflict of interests issue dissolves."

What Rights Does an Insurer Have to Information from Independent Counsel?

Under California law, "When independent counsel has been selected by the insured, it shall be the duty of that counsel and the insured to disclose to the insurer all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action. Any claim of privilege asserted is subject to in camera review in the appropriate law and motion department of the superior court. Any information disclosed by the insured or by independent counsel is not a waiver of the privilege as to any other party." Cal. Civ. Code sec. 2860 (d).

Under California law although *Cumis* counsel does not owe any fiduciary duty to the insurer, Cumis counsel, as well as the insured, owe a statutory duty to the insurer to disclose all information concerning the action except privileged materials relevant to coverage disputes, and timely to inform and consult with the insurer on all matters relating to the action. *Assurance Co. of America v. Haven*, 32 Cal.App.4th 78, 38 Cal. Rptr. 2d 25 (1995).

Further the insured still has a duty to cooperate. And the insured can always associate in its own counsel if there is a problem with independent counsel. "(f) Where the insured selects independent counsel pursuant to the provisions of this section, both the counsel provided by the insurer and independent counsel selected by the insured shall be allowed to participate in all aspects of the litigation. Counsel shall cooperate fully in the exchange of information that is consistent with each counsel's ethical and legal obligation to the insured. Nothing in this section shall relieve the insured of his or her duty to cooperate with the insurer under the terms of the insurance contract." Cal. Civ. Code sex. 2860 (f).

When Must an Insurer Split Its File Handling?

Under California law, while defense counsel hired by an insurer is attorney to both the insured and insurer, an adjuster hired by the insurance company is the agent of the insurer, not the insured. That adjuster may properly handle both the underlying liability claim and the coverage claim. *State Farm Fire & Cas. Co. v. Superior Court*, 216 Cal. App. 3d 1222, 265 Cal. Rptr. 372, 373 (1989). There the insurer reserved its rights to dispute coverage in the liability action. It provided independent counsel to the insureds. The insurer then retained other counsel to pursue its declaratory relief action disputing coverage. The same insurance adjuster handled both the liability action and the coverage action. The court held that the requirement that the insurer provide the insured with independent counsel adequately protects the insured's interests, and it is

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not necessary for the company also to provide different adjusters for the liability and coverage actions. *Id.*, 216 Cal. App. 3d at 1227.

There may be reasons to split the file. If a bad faith lawsuit is anticipated, it will be more difficult to prevent discovery of the coverage side of the file, if discovery is sought for the liability side of the file in that bad faith lawsuit. Also, if the insured agreed to panel defense counsel, the protection of the insured perceived by the court in *State Farm v. Superior Court, supra*, 216 Cal. App. 3d 1222 would not be present, and this might affect a court's judgment on this issue.

Choice of Law

There can be a question about choice of law. If the policy is issued in one state, and the lawsuit against the insured is brought in another state, which law should apply?

For example, in *N. Ins. Co. v. Allied Mut. Ins. Co.*, 955 F.2d 1353, 1359 (9th Cir. 1992) the policy was issued in California, but the lawsuit was pending in Washington. Washington rules of professional conduct applied to govern the conduct of the lawyers defending the insured. But the policy was issued in California to an insured located there. The court determined that California law should be applied to the question of the right to independent counsel. "The underlying concern is not, however, the enforcement of ethical rules, but rather the protection of the insured when its interests conflict with those of its insurer. Cumis, and now section 2860, accomplishes this by requiring insurers to provide independent counsel when a conflict arises. California has a strong interest in protecting its insureds from the risks inherent in a defense provided under a reservation of rights. *Id.*, 955 F.2d at 1359.

Withdrawing in Whole or in Part the Reservation of Rights

An insurer can, as a matter of business judgment, decide not to assert a reservation of rights, if on balance that is the prudent thing to do. That requires a careful evaluation of the risk of doing so against the benefits of maintaining control of the defense with approved panel defense counsel.

Insurers will reserve some rights and not others (e.g. intent based defenses) sometimes so as to have reserved some rights, but not so many rights as to require appointment of defense counsel. If a coverage defense is weak, or relatively minor, an insurer may want to consider undertaking the defense of the liability action without a reservation of rights, in effect waiving those weak or minor coverage defenses.

Conflicts between Insureds

Claims between insureds include claims between an insured as indemnitor and its indemnitee under contractual liability coverage between employers and employees, among a corporation and its directors and officers. Some of these have been discussed above.

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In *Murphy v. Urso*, 88 Ill.2d 444, 430 N.E.2d 1079 (1981) a passenger in a bus, who was injured in an accident, sued the driver and the preschool that owned the bus. The court noted the conflicts between the insurer and the driver, and as well between the driver and the preschool. The preschool would want to show that the driver did not have permission to use the bus at the time of the accident. It would show either that he had been discharged or was not operating within the scope of his employment, or that he had no explicit or implicit approval to use the bus. This would exonerate the school. But the driver would to try to show that he did have permission to use the bus, which would spread the liability to the preschool. The driver would want to show that he had not been fired and that his use of the bus was within the scope of his employment, or that he had received approval for the use of the bus to help a friend move.

In *Indus. Indem. Co. v. Great Am. Ins. Co.*, 73 Cal. App. 3d 529, 531, 140 Cal. Rptr. 806, 807 (1977) a contractor worked for a city on a project. There was a construction site death of a subcontractor's employee. The city was an additional insured on the contractor's policy, but there was an exclusion for "active, independent negligent conduct". Evidence of such active, independent negligence developed. Defense counsel and contractor's insurer discussed the matter with city's insurer, which declined to get involved. Defense counsel sent a reservation of rights letter to the city, on behalf of the contractor's insurer. The contractor's insurer settled that action, allocating a larger share of that settlement to the city. Contractor's insurer then sued the city and its insurer, asserting the "active, independent negligent conduct" of the city and demanding reimbursement. Contractor's insurer was represented by the same attorney. The court held that the attorney had represented conflicting interests in the prior action, in view of the contractor's insurer's contention that the city's additional insured coverage under its policy was not as broad as the city's exposure to liability in the prior action, and in view of the city's possible right of indemnity against the other insurer.

Conclusion

Conflicts of interest can complicate claims handling tremendously. There is often little time at the beginning of a lawsuit, when a responsive pleading is due, to analyze conflicts that may be presented by a claim. An insurer needs to act quickly to protect its insureds' interests as well as its own. Further conflicts can develop during litigation as evidence is developed, and as the parties refine their arguments and theories of liability. This requires careful and consistent attention by claims handlers, and an awareness of such issues.

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