THE LEGAL OBLIGATIONS OF AN INSURER THAT HAS OBTAINED INFORMATION FROM APPOINTED DEFENSE COUNSEL THAT SUPPORTS A DENIAL OF COVERAGE

Tony Zelle: Zelle McDonough & Cohen

There are many ethical issues that challenge attorneys in the tripartite relationship with an insurer and the insured the attorney has been assigned to defend. One that has no easy answer, for the attorney or the insurer, stems from the attorney's possession of information that could be relied upon by the insurer to disclaim coverage. What should defense counsel do? Can he tell the insurer the information if he knows it could hurt the policyholder? Can he withhold the information from the insurer, knowing that the insurer has a contractual right to deny coverage? Addressing the challenge begins with the predicate that there is an attorney-client relationship with both the insurer and the policyholder and the primary client is the policyholder.

The ABA Model Rules of Professional Conduct provides guidance to defense counsel facing this scenario. Model Rule 1.6, Confidentiality of Information, requires that a "lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation" or one of the narrow exceptions in paragraph (b) permits the disclosure. On the other hand, Model Rule 1.4 requires a lawyer to "keep the client reasonably informed about the status of the matter" and to "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." In a formal opinion, the ABA Committee on Ethics and Professional Responsibility directly addressed this issue, noting that a lawyer may not reveal information gained from an insured "or use it to the benefit of the insurance company, when the revelation might result in denial of insurance protection" for the insured. Formal Opinion 08-450 at 5. Further, the Committee stated,

> [T]he insured is required, as a condition of the insurance protection, to cooperate and assist in the defense, and, implicitly, to reveal to the lawyer all pertinent information known to the insured. None of that, however, undermines the insured's right to expect that the lawyer will abide by Rule 1.6 and withhold from the carrier information relating to the representation that is damaging to the insured's interests under the policy.

Formal Opinion 08-450 at 7.

The ethical loophole in this Opinion lies in the fact that the policyholder's contractual obligation to cooperate and assist in the defense does not obligate the policyholder to share information that may not be integral to the defense. Put another way, while a policyholder may have an ethical obligation not to seek coverage if he knows, after the defense counsel has explained the matter "to the extent reasonably necessary to permit the client to make informed decisions regarding the representation," if the policyholder does not make the ethical decision, he is likely to get coverage he does not deserve.

The policyholder's ethical dilemma is not the subject of this article, nor is it about the defense attorney's ethical obligations as they are spelled out quite clearly by the rules and Opinions like Formal Opinion 08-450 cited above. Rather, this article explores the legal obligations of an insurer that has obtained information that supports a denial of coverage from defense counsel who did not know that sharing the information with the insurer would preclude coverage.

It is incumbent on insurers to engage defense counsel who have a basic understanding of common coverage issues. Insurers must put themselves in a position to protect themselves and their defense counsel against problems prescribed by the rules of ethics and professional responsibility that may arise from the disclosure of information in the course of the investigation and defense of a claim. Defense counsel who are aware of these ethical issues will refrain from revealing information to the insurer that could affect its coverage determination and will know how to communicate with the insurer in a manner that will not impair the policyholder's rights or the insurer's rights to disclaim coverage when warranted by the fact. In contrast, a problem for an insurer will arise when defense counsel does not understand how information he shares with the insurer may affect coverage. When information that adversely affects an insured's coverage is disclosed because the defense counsel does not know it will have that effect, the lawyer's ignorance may prevent a finding that the ethical rules were violated; but it may not protect the insurer's contractual rights. The limited legal authority addressing the issue suggests that an insurer can be estopped from disclaiming coverage based on information it obtains from defense counsel, even if defense counsel was not providing advice concerning coverage and was unaware that the information it provided affected coverage.

This dilemma is illustrated by *Parsons v. Continental National American Group*, 550 P.2d 94 (Ariz. 1976), in which the Arizona Supreme Court held that CNA was estopped from disclaiming coverage based on information provided by defense counsel, despite the fact that the decision does not identify evidence that would support the inference that the attorney knew that the information provided would affect coverage. In addition, there is no indication the attorney was found to run afoul of the ethical rules prohibiting such a disclosure.

In *Parsons*, the claimants alleged they were assaulted by their neighbor's fourteen year old child. CNA hired defense counsel to investigate the claim and to defend its insureds. Defense counsel told CNA that he obtained:

> a rather complete and confidential file on the minor insured who is now in the Paso Robles School for Boys, a maximum-security institution with facilities for psychiatric treatment, and he will be kept there indefinitely and certainly for at least six months . . . The above referred-to confidential file shows that the boy is fully aware of his acts and that he knew what he was doing wrong. It follows, therefore, that the assault he committed on claimants can only be a deliberate act on his part.

After receiving this information, CNA sent a reservation of rights letter to the insureds stating that it would investigate and defend the claim under a full reservation of rights. The letter explained that it was possible that the act involved might be found to be an intentional act and

that the policy specifically excluded liability for bodily injury caused by an intentional act. In the underlying case, the trial court granted the claimants' motion for a directed verdict after the defense presented no evidence and there was no opposition to the motion. Judgment was entered in the amount of $50,000. The claimants then garnished and CNA successfully defended the garnishment action by claiming that the intentional act exclusion applied. Defense counsel that had previously represented the insureds in the underlying action represented CNA in the garnishment action.

The Arizona Supreme Court held that CNA was estopped from denying coverage and waived the intentional act exclusion because CNA "took advantage of the fiduciary relationship between its agent," the defense attorney, and the insureds. 550 P.2d at 97. Then, with a scant evidentiary basis, the court attributed an improper intent to defense counsel and wrote: "[w]hen an attorney who is an insurance company's agent uses the confidential relationship between an attorney and a client to gather information so as to deny the insured coverage under the policy in the garnishment proceeding we hold that such conduct constitutes a waiver of any policy defense, and is so contrary to public policy that the insurance company is estopped as a matter of law from disclaiming liability under an exclusionary clause in the policy." 550 P.2d at 99. The intent appears to be inferred from the defense counsel's report that concluded: "the assault he committed on claimants can only be a deliberate act on his part," though the court failed to make a finding that defense counsel knew that intentional acts are excluded.

The holding in *Parsons* stands in stark contrast to *Employers Casualty Co. v. Tilley*, 496 S.W.2d 552 (Tex. 1973), where the defense counsel's intent to benefit the insurer to the detriment of the policyholder was not inferred. Defense counsel sent evidence, information, and briefs to the insurer, at its request, that supported the insurer's late notice investigation. The insurer then hired defense counsel to defend the insured in a lawsuit based on its alleged negligence. Defense counsel led the insured to make his employees available for statements, one of which had as a purpose the development of late notice evidence against the insured. This statement was taken by defense counsel at the request of the insurer. Over the course of a year and half, defense counsel wrote several letters to and had several telephone calls with the insurer regarding developing its coverage defense, additional investigation, and advising on the legal possibilities of establishing a coverage defense. Defense counsel never advised the insured that there was a conflict of interest, that he was providing information to the insurer regarding the late notice issue, or that the statements taken were going to affect the insurer's coverage determination. The court held that prejudice against the insured was shown as a matter of law and that the insurer was estopped from denying coverage. The court also held that a general non-waiver agreement that the insured signed did not relieve the insurer of its duty to inform the insured of the specific conflict or relieve the insurer of the consequences of its failure to inform the insured.

In *Medical Mutual Liability Insurance Society v. Miller*, 451 A.2d 930 (Md. App. 1982), Medical Mutual assigned its own general counsel to represent the insured. The court determined that an apparent conflict of interest arose when the insured disclosed to defense counsel that he had not explained the potential risks of the surgical procedure to the patient. According to the court, Medical Mutual's interest in pursuing the option of disclaiming liability was in direct conflict with the insured's interest in maintaining his malpractice insurance coverage. The court held

that defense counsel's continued representation of the insured prejudiced the insured to such an extent that Medical Mutual was estopped from disclaiming liability.

Medical Mutual distinguished *Fidelity & Casualty Co. v. McConnaughy*, 179 A.2d 117 (Md. Ct. App. 1962), in which the court held that the insurer was not estopped from disclaiming coverage because the insurer could have obtained the same information from sources other than defense counsel. In *McConnaughy*, defense counsel informed the insurer that the insured admitted he requested a third party witness to falsely testify that he had observed the car accident at issue and that the insured was not at fault. The insured argued that the insurer was estopped from disclaiming coverage because the disclaimer was based on information defense counsel provided to the insurer in violation of defense counsel's duty of confidentiality to the insured. The court agreed that defense counsel breached his duty to the insured, but determined that the insurer was not estopped from disclaiming coverage because the insurer could have obtained the same information from other sources. The court explained that "[t]he insurer, through its own claim investigator, or through counsel who did not represent [the insured], could have ascertained what [the insured] disclosed to his lawyers, if it did not already know it well enough from [the third party witness's] deposition, and then could have disclaimed. We are not persuaded that because the company verified its belief that there had been a breach of the policy provisions by [the insured], through lawyers who continued to represent it and the insured at a time when their interests were not parallel, it lost whatever rights it otherwise would have had." 179 A.2d at 122.

The *McConnaughy* case supports the premise that if defense counsel unknowingly provides information that could adversely affect the policyholder's coverage and the insurer independently develops that evidence or other facts supporting a coverage disclaimer, it can rely on the independently developed information to disclaim coverage, even though it also obtained information from defense counsel. If the only evidence the insurer has to disclaim coverage is the information obtained improperly from defense counsel, the insurer would likely not have had a basis to disclaim that would have been approved by the *McConnaughy* court.

When presented with information from defense counsel that could support a denial of coverage, the prudent insurer will split the file and maintain a defense file, in which the information provided by counsel is recorded, and a coverage file, where the information is not known to the claim professional. This will ensure that the coverage determination is made independently of the information obtained by defense counsel. Taking this step will place the insurer in a sound basis to defeat any bad faith claim.

Mr. Zelle has developed a national reputation representing insurance companies in coverage and bad faith claims. He was elected to the Defense Research Institute's board of directors in 2014. Previously, he served as Chair of DRI's Insurance Committee. As chair of the Bad Faith and Extra-Contractual Claims Subcommittee, he compiled and edited the first edition of the Compendium of Bad Faith Law in 2002. Mr. Zelle has tried and handled the appeals of the leading bad faith cases in Massachusetts and Rhode Island and has handled bad faith litigation across the country.